MEMORANDUM

OFFICE OF COMPLIANCE
INSPECTIONS AND EXAMINATIONS

TO: Dan Gray

FROM: Lori Richards, John McCarthy, Eric Swanson, Mark Donohue and Matt Daugherty

RE: Bernard L. Madoff Investment Securities, LLC

DATE: March 4, 2004

I. Introduction

In January 2003, the Staff from the Office of Compliance, Inspections and Examinations ("Staff") began an examination of Bernard L. Madoff Investment Securities, LLC ("Madoff") based on numerous complaints regarding improper activity at the firm. The allegations centered on trading by various hedge funds run by principals of the firm. Madoff provided to the funds order flow data it received through its market making activities, and the funds then used market trends apparent in the trading patterns of Madoff's large customer base to determine the direction of the market, and in addition, potentially trade ahead of the pubic customer orders before they were allowed executions. As explained in the following memorandum, the Staff finds that Madoff may be misappropriating material nonpublic information relating to customer orders, and allowing the funds to profit from this order flow data in violation of various anti-fraud provisions of the Exchange Act as well as NASD rules.

II. Background

Madoff is a NASD registered broker/dealer which makes markets in both Nasdaq and Exchange listed securities. According to information provided to the Staff, Madoff or principals of the firm also operates several hedge funds that are based on a single automated "split-strike conversion" strategy. Based on pre-programmed parameters, the funds buy and sell large baskets of large capitalization stocks contained in the S&P 100, and hedge the investment with S&P 100 index options.[1] Normally considered a fairly conservative strategy, the funds have returned XX per year over the last XX years.

[1] In order to ensure that the position can be adequately hedged with the index option, the funds will only buy or sell when a certain percentage of index components (e.g., 70%) meet the pre-defined criteria.

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Madoff does not charge a significant management fee for these funds, which have $XX in assets,[2] rather, it receives a commission for each trade made by the fund of $XX per 100 shares.

The Staff has learned that Madoff may be routing order information obtained in the ordinary course of its market making operations to its hedge funds' automated execution system in order to execute in anticipation of significant market trends. For instance, if Madoff notes significant buying activity in a sufficient number of index components, it will purchase those securities and hedge with index options.

III. Analysis

A. Order Information

The potential for illicit profit from information concerning customer orders is apparent in the Exchange Act and SRO regulations with respect to order information. With regard to specialists on an exchange, Section 11(b) of the Exchange Act states in pertinent part:

> "It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist."[3]

Thus specialists are expressly prohibited from providing order flow data in specialty stocks to anyone except for three limited exceptions. There is, however, no such express prohibition against broker-dealers making a market in OTC securities. Historically, this may have been due to the fact that the market and order flow in OTC securities was much more fragmented and spread across several dealers, as opposed to specialists, who are aware of all order flow in their particular securities as the collector of all order flow information. However, advances in technology and the sophistication of market makers may have made it possible for them to predict market trends and capitalize from that information themselves, or disseminate (*i.e.*, tip) the information to other parties. For instance, Knight Securities former CEO stated that they had in "informational advantage" due to their large market position, and that that "[Knight is] smarter than the market in aggregate and [Knight is] able therefore to made a determination whether the stock will go up or down."[4] Accordingly, the lack of a specific prohibition against the misuse or dissemination of this order flow information in the OTC market is the product of market structure and information evolving more

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2 Although the funds have XX in assets, 4 of the funds contained XX% of the assets managed by principals of Madoff.

3 Exchange Act Section 11(b).

4 "Catbird Seat: Nasdaq Market Maker, Seeing All the Orders, Becomes Canny Trader", by Greg Ip, Wall Street Journal (March 3, 2000).

quickly than the regulatory scheme, and not a specific exemption carved out for OTC broker-dealers.

B. Order Flow Data - Material Nonpublic Information

A plain reading of Section 11(b)'s prohibition against specialists' dissemination of order information implies Congress' affirmation that the information was material, and thus enacted the statute to prevent its dissemination in order to prevent its misuse and allow other parties, who do not share the specialists' affirmative obligation to maintain a fair and orderly market and step in *against* the market trends, to capitalize from the information.[5] The materiality of order flow data, especially for a firm as large as Madoff which possesses information concerning millions of shares each trading day, is not only implied by Section 11(b), but in rules such as those against frontrunning. It is well settled that SROs generally define frontrunning as the practice of trading a security while in possession of material nonpublic information regarding an imminent block transaction in the same or related security.[6] Thus block transactions, which in some cases may include transactions of less than 10,000 shares, are in essence considered *prima facie* material. Certainly, if information concerning one order of 10,000 shares is considered material, then order information concerning millions of shares, by virtue of being block transactions or the aggregate of numerous smaller orders, is also material.

C. Dissemination and Misappropriation of Material Non-Public Information

While the 11(b) prohibitions do not specifically apply to OTC broker-dealers, there are statutes and rules, which concurrently prohibit this practice in the OTC market. First, Section 10(b) and Rule 10b-5 of the Exchange Act clearly prohibit the misappropriation of material nonpublic information in breach of a fiduciary duty to the source of the information.[7] In this case, while the firm could clearly trade for its own market making account while in possession of the order flow data, principals of the firm misappropriated material nonpublic information by virtue of allowing the hedge funds access to the information, in violation their duty to the firm and its customers, the source of the information. The O'Hagan court noted that a "misappropriator who trades on the basis of material nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public."[8]

The commission has also noted in an analogous example that it may constitute insider trading via misappropriation if a market maker misuses customer block order information by engaging in extraordinary trading for his own account or otherwise in a

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5 Exchange Act Rule 11b-1.

6 *See,* Exchange Act Release No. 34-25233, 53 FR 296 (1987), NASD Rule 2110 and IM-2110-3.

7 U.S. v. O'Hagan, 117 S.Ct. 2199 (1997).

8 Id. at 2209.

manner inconsistent with the purpose for which it was given to the broker.[9] In this case there is no pretense that Madoff was fulfilling its duties as a market maker while in possession of order flow information, as the information had been routed to the hedge funds in order for them to profit without providing any liquidity to the order flow received by Madoff. Allowing the funds to free-ride off the information provided to Madoff and profit without taking any of the risks associated with being a market maker is a clear violation of Exchange Act Section 10(b), as the court in O'Hagan noted that "the misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities."[10]

Furthermore, NASD rules deem the misuse of certain order information a violation of Rule 2110, which requires members to observe high standards of commercial honor and the just and equitable principles of trade.[11] For instance, the NASD specifically lists frontrunning, in IM-2110-03 as a violation of this rule. As noted above, the misuse of material nonpublic information by principals of Madoff in this matter are sufficiently similar to frontrunning, and thus constitute a violation of Rule 2110.

Finally, the firm can be held liable under Section 15(f) of the Exchange Act for violations by persons associated with the firm. The Insider Trading and Securities Fraud Enforcement Act, under which Exchange Act Section 15(f) was passed, states:

> "Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rule or regulations thereunder, of material nonpublic information by such broker or dealer or any person associated with such broker or dealer."

Accordingly, under the statute broker-dealers are required to have adequate policies and procedures in place to prevent the misuse of material nonpublic information by the firm or persons associated with the firm. Even assuming that some procedures were in place at the firm during the time of the violative conduct, a failure to enforce the policies with respect to a fraud as large as the one in the case at bar would clearly be a violation of Section 15(f).

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9 Selective Disclosure and Insider Trading, Exchange Act Release No. 43154, 2000 WL 1201556 (2000), Footnote 125.

10 U.S. v. O'Hagan at 2209.

11 NASD Rule 2110.