MEMORANDUM

Dection Courses

TO:

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FROM:

Mark Fitterman 197

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RE:

Special Purpose Inspections of Bernard L. Madoff Investment Securities and

DATE:

July 19, 1994

Introduction

Over the past several years, third market makers and proprietary trading systems ("PTSs") have captured an increasing amount of volume in New York Stock Exchange "NYSE") and National Association of Securities Dealers Automated Quotation ("NASDÁQ") stocks. Under the present regulatory structure, however, these entities are regulated as broker-dealers. The Division's Market 2000 Study ("Study") reviewed the regulatory structure of third market makers and PTSs and found that the National Association of Securities Dealers' ("NASD") examination process focussed on these entities as broker-dealers and overlooked issues relating to market performance. The Study team requested that the staff from the Division's Office of Market Operation and Surveillance Inspections ("Staff") conduct special purpose inspections of the trading systems of these entities in light of certain market structure issues raised in the Study.

For this reason, in July 1993, the Staff conducted inspections of Bernard L. Madoff Investment Securities ("Madoff") and the Examination Materia Staff was requested to review the following issues: payment for order flow, order execution procedures, market order price improvement procedures, performance as market makers, surveillance of the automated execution systems, ITS trading procedures, and audit trail of these broker-dealer trading systems.² Reports with specific findings and recommendations of the inspections of Madoff and Instinet are attached in Exhibits 1 and 2 respectively.

II. Description

Madoff is registered as a designated dealer on the Cincinnati Stock Exchange and as a third market maker with the NASD in exchange-listed securities. Examina

Staff participating in the inspections included Personal Privac

See Memorandum dated March 29, 1993, from Personal Privacy

The Study team was orally apprised of the findings of the inspections.

The NASD is the designated examining authority for both Madoff and Material For regulatory purposes, the Division views both Madoff and Material as broker-dealers subject to the recordkeeping requirements of Rules 17a-3 and 17a-4 under the Securities Exchange The attached reports discuss in detail the operation of the two trading systems, compliance procedures,

and programs for regulatory oversight.

Ш. Findings and Recommendations

A. Madoff

The Staff found that, overall, Madoff's automated execution systems were functioning as represented to the Division. The Staff did, however, identify certain deficiencies that may exist in Madoff's market order price improvement subsystems.

In addition, the Staff found that the oversight examination administered by the NASD is adequate for surveillance of a typical market maker on NASDAQ. The Staff believes, however, that Madoff operates more as an integrated market center and that NASD oversight examinations should be revised to include certain market structure issues not included in the routine broker-dealer examination conducted by the NASD. These issues include: automated trading or execution systems, ITS trading and quotation activities, and payments for order flow.

∄IV. Conclusion

The attached reports provide an overview of the findings and recommendations resulting from the Staff's inspections. Because the inspections were neither routine inspections of SRO programs nor routine examinations of broker-dealer operations, we will not issue formal inspection reports to Madoff or Examination Ma

As a result of a recommendation from the Study, the Division proposed Rule 17a-23 to establish a uniform comprehensive recordkeeping and reporting structure for brokerdealers sponsors of "broker-dealer trading systems," ("BDTS") ⁴ Proposed Rule 17a-23 would require these BDTSs (which would include Madoff and the Commission and the SROs that separately identify transactions effected through the BDTSs, summarize system volume, identify traded securities, and describe the operation of the system. Although proposed Rule 17a-23 has not yet been approved, the Staff believes that the proposed rule would allow the NASD and the Commission to better meet their regulatory oversight responsibilities for BDTSs.

The Study also recommended that the NASD develop a comprehensive program for examining third market activity and submit it to the Commission. In addition, the Study proposed five trading principles to which third market makers should adhere: (1) display of customer limit orders that are better than the existing ITS best bid or offer (to the same extent that the exchanges impose such an obligation on their specialists); (2) customer limit order protection; (3) crossing of customers' orders, if possible, without dealer intervention; (4) fixed standards for queuing and executing customer orders; and (5) compliance with ITS trade-through and block policies. The Study recommended that the NASD submit a rule change to the Commission to incorporate these five principles.

The results of the Staff's inspections demonstrate a need for both an examination program for third market activity and the implementation of the five trading principles. The Staff intends to work with the NASD to develop an examination module that would encompass reviews of third market activity and BDTS in order to implement the recommendations from the Study and proposed Rule 17a-23. The Staff plans to send a letter to the NASD indicating that we will be contacting them to discuss the expanded examination programs for BDTS.

See Release No. 34-33605 (February 9, 1994), 59 FR 8368.