

MEMORANDUM

IS
Belter
Madoff's
Counsel?

TO: Brandon Becker
Bob Colby

FROM: Mark Fitterman
Mary Ann Gadziala

RE: Special Purpose Inspections of Bernard L. Madoff Investment Securities and
the [redacted]

DATE: July 19, 1994

I. 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 ("NASDAQ") 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 [redacted].¹ Specifically, the 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.³

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. [redacted]

¹ Staff participating in the inspections included [redacted]

² See Memorandum dated March 29, 1993, from [redacted] and [redacted]

³ The Study team was orally apprised of the findings of the inspections.

dealers sponsors of "broker-dealer trading systems," ("BDTS")⁴ Proposed Rule 17a-23 would require these BDTSs (which would include Madoff and Examination Material to file reports with 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.

⁴ See Release No. 34-33605 (February 9, 1994), 59 FR 8368.