# MADF QQQ Memo

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**Attachments:** Madoff Memo.doc

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Tom:

Here is the memo I have drafted for what I have found at MADF. Please let me know what the next step should be.

OCIE Staff Attorney

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# MEMORANDUM

To: Tom Eidt

From: OCIE Staff Attorney [redacted]

Date: September 12, 2003

RE: Madoff Activity on QQQ

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I have investigated the trading activity of the Nasdaq market maker Bernard L. Madoff Investment Securities, LLC (MADF) in the Nasdaq 100 Exchange Traded Fund (QQQ) for the days of January 6, 2003 to January 10, 2003. We decided to investigate trading in this security based on the fact that the market for QQQ is often locked[1] or crossed.[2] We had suspected that when one of these types of markets exists for a security that market makers and specialists were violating their duty of best execution on customer trades. As detailed below, I have come to the conclusion that MADF specifically has violated their duty of best execution for a number of trades although perhaps not with the frequency that was expected.

## I. Stated MADF Policies

### *A. General Order Handling.*

Because of the nature of the legal environment surrounding OTC market maker's duty of best execution,[3] I have outlined of those policies MADF makes public to its customers via its website.

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[1] A locked market is one where the inside bid and the inside ask are the same price.

[2] A crossed market is one where the inside bid is higher than the inside ask.

[3] *See* NASD Notice to Members 97-57, Question 8 (stating that a market maker's fiduciary duties to its customer can be breached if the market maker does not fully disclose that it will be competing with a customer's discretionary order). As outlined below at Section III, some of the MADF irregularities derive from customer stop orders, which both the NASD (in their Examination Manual) and MADF (as outlined in their "Unusual Market Conditions Policy") consider "discretionary." But as argued below, this should not relieve a market maker of their *Manning* responsibilities.

In the "Madoff's Guide to Best Execution – Nasdaq Securities"[4] (Best Ex Guide), MADF discloses that they will "instantaneously" expose lots from 100 to 3000 shares to Primex. The Best Ex Guide further states that during openings, MADF will match any executions they get proprietarily while the market is locked in the opening with unexecuted market and marketable limit orders. The Best Ex Guide also claims that "[a]s always, Madoff will never trade ahead of [a customer] order."

*B. Unusual Market Conditions Policy*

MADF has condensed their unusual market conditions policy into a "client notice" available on their website.[5] MADF fails to define unusual market conditions, but states that it is "often characterized by inordinate volumes and volatility."[6] It also states that locked and crossed markets will make an order subject to manual verification. MADF points out some of the measures it will take during unusual market conditions, including reducing the size of orders eligible for auto-ex and declining to accept new stop orders (while still honoring existing ones). Unusual markets may also lead to delays in execution reports and multiple execution prices and times for large lots outside the auto-ex size.

*C. Stated Stop Order Policies*

While MADF accepts stop orders, it does so with limitations. It uses Nasdaq Level 1 to determine whether the stop price has been reached. It does not guarantee liquidity for stop orders and treats them as a "best efforts" order.

[4] Available at http://www.madoff.com/dis/display.asp?id=353&mode=1&home=1
[5] Available at http://www.madoff.com/letters/mvl.asp?home=1 or in the Best Ex Guide at http://www.madoff.com/dis/display.asp?id=353&mode=1&home=1
[6] MADF lists the factors used to determine whether to invoke the unusual market conditions as: 1) Price volatility, 2) Number of customer orders in the security, 3) Total number of customer orders, 4) ITS availability, and 5) Customer-chosen routing service provider availability. The decision to turn a feature off can only be done by senior management, not traders and notifies customers of such decisions electronically.

## II. Large Market Order Trade Irregularities

Of the 29 questionable trades found during the period, six were market orders that involved large lots on both the MADF and customer side of the trade.[7] All are market orders that were received by MADF that MADF then sat on while it traded for its own account, resulting in a worse price for the customer. This is a best execution violation because the trading activity results in MADF profiting at the expense of their customers.[8] Also, while MADF seems to have no difficulty finding a market for their proprietary trades in locked or crossed markets, MADF will hold customer orders – probably based on the "unusual market conditions policy" outlined above. Specific instances of such conduct by MADF are outlined below.

A. *January 6*

(1)[9] At 10:34:23, American Enterprise Investment Services[10] sent a Sell 3000 at Market to MADF. The inside NBBO was crossed at 26.11 x .10. At 35:10, MADF Sells short 100 at 26.09 (26.10 x .09) at Archipelago. At 35:17, MADF Buys 100 at 26.09 (26.09 x .09) at Archipelago. At 35:22, MADF again Buys 300 at 26.08 (26.08 x .09) at Archipelago. Finally, at 10:35:32, MADF fills American Enterprise's order at 26.07 (at the :32 inside bid) resulting in a loss of $120 (0.04 per share) to the customer. The market had stabilized at points during the period while the order was open, but MADF did not execute until over a minute after receiving the order.

(2)[11] At 13:39:50, Edward Jones[12] sent a Buy 800 at Market to MADF. The inside NBBO was locked at 26.40 x .40. At 40:10, MADF Buys 2000 at 26.40 (26.41 x .40) at the Amex via

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[7] By large, I mean usually more than a thousand share lots.
[8] *See* NASD Notice to Members 01-22. I also believe that it is possible to widen the scope of *Manning* to include such trading ahead as a violation of firms' fiduciary duties even if the order is not a limit order. *See* Section III below.
[9] Access Reference 3, lines 317-20.
[10] According to MADF, American Enterprise is known by the dealer code AEI in MADF's trade reports.
[11] Access Reference 7, line 740.

PERS. Then at 13:40:47, MADF fills Edward Jones's order at 26.41 (at the :47 inside ask) resulting in a loss of $8 (0.01 per share) to the customer. The market had stabilized at 13:40:25 when the inside NBBO was the same as when it was executed.

(3)[13] At 14:27:55, US Bancorp[14] sent a Buy 2000 at Market to MADF. The inside NBBO was locked at 26.42 x .42. At 28:03, MADF fills the first 1000 at 26.42 (26.42 x .42), simultaneously Buying 1000 at the same price (assumedly in a riskless principal transaction) at Philly. Then at 14:28:51, MADF fills US Bancorp's order at 26.44 (at the :51 inside ask) resulting in a loss of $20 (0.02 per share) to the customer. The market was either locked or crossed while the order was open.

*B. January 8*

(1)[15] At 10:17:54, Raymond James[16] sent a Sell short 1700 at Market to MADF. The inside NBBO was normal at 26.29 x .30. At 18:02, MADF fills the first 100 at 26.30 (26.30 x .30), simultaneously Selling 100 at the same price for themselves (assumedly in a riskless principal transaction) at the Pacific. At 18:37, MADF Buys 100 at 26.28 (26.29 x .28) at the Pacific. Then at 10:18:50, MADF both fills the remaining 1600 of Raymond James's order at 26.25 (a point worse from the :50 inside bid) and executes a proprietary Sell Short 3000 at the same price with ABN Amro[17] via CAES. So, while not a trading ahead violation, this is a trade through that should have been executed at the inside bid. Also, it is a best execution violation because while MADF was trading for its own account, the market was more favorable than when it actually executed the trade.

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[12] According to MADF, Edward Jones is known by the dealer code EDJ in MADF's trade reports.
[13] Access Reference 8, line 826.
[14] According to MADF, US Bancorp/Piper Jaffray is known by the dealer code PJ in MADF's trade reports.
[15] Access Reference 15, line 175.
[16] According to MADF, Raymond James is known by the dealer codes RJ and RJT in MADF's trade reports.
[17] According to MADF, ABN Amro is known by the dealer code ISID in MADF's trade reports.

(2)[18] At 15:13:00, LPL Financial[19] sent a Buy 1700 at Market to MADF. The inside NBBO was normal at 25.94 x .95. At 13:11, Instanet[20] sent a Buy 1700 Limit at 25.95 to MADF (25.94 x .95). At 13:11, MADF Buys 1000 at 25.93 (25.94 x .95) from ABN Amro via CAES. At the same time, MADF fills both the LPL Financial and Instanet orders, but at 25.948. While better than the inside ask (25.95), it is almost two cents worse than the execution that MADF got for its own order thus violating the best execution duty.

*C. January 9*

(1)[21] At 10:24:12, American Enterprise placed a 9000 Sell Short at Market order with MADF. The inside NBBO was normal at 25.68 x .69. MADF partially fills the order in three steps until 10.24.44, matching each fill with riskless principal transactions along the way. The first fill (for 1000 @ 26.68 @ 10:24:34) is fine. But the last two (500 @ 26.670 @ 10:24:38 and 7500 @ 26.67 @ 24:44) were a cent worse than the inside bid (26.68 x .68) resulting in a trade throughs that should have been executed at the inside bid. Note, however, that the last fill lot, 7500, is outside MADF's automatic price improvement range.[22]

## III. Stop Order Problems

There are four stop orders that MADF has traded ahead of during the period. While this can be characterized as best execution violation, I believe that *Manning*[23] can be extended to included such violations. As it now stands, *Manning* only applies to limit orders.[24] However, the legal principle upon which *Manning* is based comes from agency law; namely, that an agent

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[18] Access Reference 30, lines 588-90.
[19] According to MADF, LPL Financial is known by the dealer code LPL in MADF's trade reports.
[20] According to MADF, Instanet is known by the dealer code INCA in MADF's trade reports.
[21] Access Reference 21, Line 205
[22] *See* Section I.A above.
[23] In re E.F. Hutton & Co. Inc., Exchange Act Release No. 25887, 49 SEC 829, 1988 SEC LEXIS 1398 (July 6, 1988). *See also* NASD Rule IM-2110-2.
[24] NASD Rule IM-2110-2. The NYSE, however, has forbidden by rule trading ahead of all orders. *See* NYSE Rule 92.

cannot profit at the expense of the principle. Although market conditions make a difference between limit and stop orders for the purposes of execution and price guarantees,[25] there is no reason to allow a firm to trade ahead of a customer stop order but forbid the same activity for limit orders. This is because of the agency law principle stated above, that an agent cannot profit at the expense of the principal. As outlined below, that is exactly what MADF has been doing.

*A. January 6*

(1)[26] MADF had a Buy Stop 902 at 25.85 on its books from First Allied.[27] At 09.33:04, MADF Sells Short 100 at 25.85 (25.86 x .84) at Archipelago. The inside ask reached the stop price at 09:33:09. MADF fills First Allied's order at 09:33:11, which executes at 25.87 (25.87 x .87) resulting in a loss of $18.04 (0.02 per share) to the customer. While looking at the inside offers at the time this seems like as good of execution as could be asked for, it seems that at 09:33:04 MADF could have executed the First Allied order at Archipelago but instead executed for themselves. This then violates the duty of best execution especially keeping in mind the Commission's and NASD guidance regarding including all market centers to guarantee best execution.[28]

(2)[29] MADF had a Buy Stop 9100 at 25.81 on its books from LPL Financial.[30] At 09.32:25, MADF Buys 5000 at 25.84 (25.81 x .82) from ABN Amro via CAES. The inside ask reached the stop price at 09:32:13. MADF fills LPL Financial's order at 09:32:44, which executes at 25.84 (25.83 x .83). MADF gave a price disadvantage to the customer by executing a cent away

[25] It is my understanding that the market is usually too fast when a stop order will execute to promise price executions.
[26] Access Reference 1, Line 61.
[27] The order was received at 14:55:42 on December 30, 2002. According to MADF, First Allied is known by the dealer code FAS in MADF's trade reports.
[28] *See, e.g.,* Exchange Act Release 37619 (September 6, 1996), NASD Notice-to-Members 01-22.
[29] Access Reference 26, Line 59.
[30] The order was received at 09:07:14 on December 30, 2002. According to MADF, LPL Financial is known by the dealer code LPL in MADF's trade reports.

from the inside ask. Also, by not executing at or near 32:13 and instead trading for their own account, MADF has committed a best execution violation.[31]

*B. January 8*

(1)[32] MADF had a Sell Stop 1000 at 26.20 on its books from "SFI".[33] At 09.58:07, MADF Sells Short 100 at 26.29 (26.30 x .29) at Archipelago. The inside bid did not reach the stop price until 11:16:08 (26.20 x .20). MADF fills LPL Financial's order at 09:58:29, which executes at 25.28 (25.28 x .29). While this trade is a better result than the customer wanted, it was not authorized to sell until the stop price was reached, which was not until over an hour later. Thus MADF exceeded its powers and breached its duty to LPL Financial causing unknown damage.

*C. January 10*

(1)[34] MADF had a Buy Stop 500 at 26.15 on its books from US Bancorp.[35] At 10.53:59, MADF Buys 100 at 27.15 (27.16 x .15) at Archipelago. The inside bid did not reach the stop price until 10:53:54 (27.15 x .15). MADF fills US Bancorp's order at 10:53:54, which executes at 27.19 (27.16 x .16). This is a major trade through and should have been executed at the inside ask, 3 cents better than the execution price. There is also a major best execution violation in comparing the price at which MADF executed a proprietary buy (27.15) and a customer buy (27.19) at the same time.

## IV. Small Market Order Trade Irregularities

In addition to the larger volume trades that are obviously the greater concern, the same type of trading activity pointed out in Section II, Large Market Order Trade Irregularities, occurred at various times throughout the period of January 6, 2003 to January 10, 2003. These trades make

[31] Or the *Manning* extension argued for above.
[32] Access Reference 13, Line 120.
[33] The order was received at 09:45:18 on January 8, 2003.
[34] Access Reference 31, Line 385.
[35] The order was received at 10:53:47 on January 10, 2003.

up the remainder of the trades in the Access database entitled "Madoff Questionable Trades" posted on the J drive. Thus, there are 19 trades of this variety. While in volume they may not make much, they show a pattern of activity at MADF. It should also be noted that there were 29 problems with best execution at MADF for one week in a year, a week which did not include any option expirations.

### V. "741" Irregularity

As stated in the introduction, there were a total of 36 trades, including partial fills, that MADF executed for the same client, Raymond James. All of these trades were Buys completed throughout the day of January 7, 2003 for 741 shares. There is a good chance that these were one side of a matching scheme or that they were being marked by someone to help embezzle. Of course, it is just as likely that they were one side of legitimate day trading activity. Regardless, they should be looked into further. The trades have been pasted into a separate Excel spread sheet on the J drive under the file name of "741 Trades."

### VI. 1998 Third Market Inspection Report and Conclusion

In 1998, the Staff conducted an inspection on "third market" firms (NASDAQ firms that execute orders on listed securities) to evaluate execution quality. This inspection included MADF and also analyzed how orders are treated during locked or crossed markets. In this report, the Staff found that MADF traders would execute orders received during locked or crossed markets at the price quoted on the primary exchange before the market locked.[36] At the time, the Staff recommended that MADF either execute the orders either at the locked price or wait until the NBBO unlocked and execute at that time.[37] The later seems to have been adopted by MADF. However, in light of MADF apparently having the ability to execute away from the

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[36] 1998 Report page 14.
[37] *Id.*

primary market as demonstrated by the data provided at the cost to the customer, a better approach may be to require MADF and other QQQ firms to execute at an ECN if the price is better and the volume is there. As has been demonstrated, there is enough liquidity at Archipelago and other ECNs to execute proprietary orders. Instead of executing proprietary orders at the better ECN price, MADF should have to pass on the better prices to the customer.