

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

ORIGINAL

JUL 24 2006

In the Matter of:)
 CERTAIN HEDGE FUND) File No. NY-7563
 TRADING PRACTICES)

WITNESS: Bernard Madoff
 PAGES: 1 through 122
 PLACE: Securities and Exchange Commission
 3 World Financial Center, Room 423
 New York, New York 10281
 DATE: Friday, May 19, 2006

The above-entitled matter came on for hearing, pursuant to notice, at 10:05 a.m.

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APPEARANCES:

On behalf of the Securities and Exchange Commission:

DORIA G. BACHENHEIMER, ESQ.

MEAGHAN CHEUNG, ESQ.

STEPHEN JOHNSON, ESQ.

SIMONA K. SUH, ESQ.

PETER LAMORE, COMPLIANCE EXAMINER

Securities and Exchange Commission

3 World Financial Center

New York, New York 10281

On behalf of the Witness:

BERNARD MADOFF (Pro Se)

New York, New York 10022

1 THE WITNESS: Yes.

2 NOTARY PUBLIC: My name is Lillian Gordon. I'm
3 commissioned in Kings County. My commission expires March
4 2006.

5 Whereupon,

6 BERNARD MADOFF,

7 having been first duly sworn, was examined and testified as
8 follows:

9 MS. SUH: Please state and spell your full name
10 for the record.

11 THE WITNESS: Bernard L. Madoff, M A D O F F.

12 MS. SUH: Prior to the opening of the record, you
13 were provided with a copy of the Commission's Supplemental
14 Information Form. A copy of that form has been marked as NY-
15 7563 Exhibit 1.

16 Have you had the opportunity to read Exhibit 1?

17 THE WITNESS: Yes, I have.

18 MS. SUH: Do you have any questions concerning
19 this exhibit?

20 THE WITNESS: No.

21 MS. SUH: Mr. Madoff, are you represented by
22 counsel?

23 THE WITNESS: No.

24 MS. SUH: You have the right to be accompanied,
25 represented and advised by counsel. This means that you may

1 was talking to a brain surgeon and they started talking about
2 the terminology that I wouldn't know, but if they said see
3 this scalpel, stick it in there, now I understand. Well, so
4 I'm saying that you're cooking a meal. You put in carrots
5 and oranges and a whole bunch of stuff. You put it into a
6 blender. If you let it run for two minutes, it's going to
7 have one consistency. If you let it run for three seconds,
8 it's going to be a different consistency and so on and so
9 forth.

10 Depending on what you're looking for, everybody is
11 looking for different things, so people design their systems
12 to say I don't care about this stuff, I care about that.
13 Again, I don't attach too much importance to the information
14 that flows out of that stuff. It's available to anybody.
15 It's not unique data. It is a -- people are always trying to
16 ask me what makes a good trade or why can you trade better
17 than other people and so on. It's the same thing. We are
18 proprietary traders and market makers. Some guys have more
19 guts than others. Some of them are just stupid. They don't
20 get frightened when they should be getting frightened. Some
21 people feel the market. Some people just understand how to
22 analyze the numbers that they're looking at. Everybody is
23 different. For me, our market makers for example, when they
24 trade, if you look at our market makers, they don't make a
25 decision as to what to buy and sell. Our system

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1 in the morning until 9:00.

2 Q The execution, does it all happen electronically?

3 A Yes.

4 Q Now you said the firm has an affiliate firm in
5 London --

6 A Yes.

7 Q Madoff Securities International Limited. Correct?

8 A Correct.

9 Q What role does it play in the trading for the
10 institutional --

11 A None.

12 Q None whatsoever?

13 A In the execution side? No, because first of all
14 they only trade foreign securities over there. They only
15 trade a couple of USA DRs, but basically they're trading
16 foreign securities.

17 MR. LAMORE: From an administrative perspective,
18 are they involved with the equities at all?

19 THE WITNESS: They're the liaison on the selling
20 side but not on the trading side, no.

21 Q And how are the equities' trades cleared?

22 A The equity trades are all cleared through us
23 because they're U.S. securities.

24 Q So the firm --

25 A Right.

1 Q Now going to the options trades, how are those
2 trades executed?

3 A The options trades, orders are placed based upon
4 the conditions. We put out an order to buy 13,000 contracts
5 with -- basically what we do is we go ahead, once we buy the
6 basket shares, we determine what the price of what, how we're
7 looking to hedge it. Basically there are a dozen derivative
8 dealers that participate in the process, and what we
9 basically do is I'll call up and say I'm interested in buying
10 -- very typically what I say is I'm looking to buy this put
11 at this price and size. Come back to me. I'll put that out
12 with all of these dealers. That's the way it's typically
13 done, and then they come back. They decide amongst
14 themselves or they will call their institutional clients in
15 Europe, and they'll come back and offer them to us and say I
16 can do X at a price and so on and so forth, and then what we
17 do, based upon if we complete the whole basket of contracts,
18 we want to do it all at one price, it's not like an average
19 price, a transaction like it is on the equity side. We then
20 will go back to them and say okay, now we go back and
21 determine the price before we get an indication from them as
22 to whether they're going to be able to trade at the level
23 that we think the order should be at. They'll come back and
24 say to us, okay, I'm going to sell it at 8 «, some will say
25 I'm going to sell it at 8, and based upon what we determine.

1. is where we're going to be able to buy the whole amount, we
2. then go back and say we'll buy at this price of this option.
3. They then come back to us and actually complete the
4. transaction. They affirm that this is the price.

5. Q So --

6. A -- - to what we would do on the floor.

7. Q So the first step is calls from you to a number of
8. dealers.

9. A Right.

10. Q Do you tell them the total amount?

11. A No. No one knows the total of what they're going
12. to do.

13. MR. LAMORE: Do you say both puts on calls or do
14. you say calls on puts?

15. THE WITNESS: We do both, but first we do the puts
16. and then we do the calls. One piece at a time.

17. Q So you don't present this as a package basically,
18. that the same person has to take both sides.

19. A No.

20. Q And the price that you indicate in your first
21. contact, you may change somewhat.

22. A It will change. Well, depending on -- it might not
23. based upon if everybody wants to trade at that price, it
24. wouldn't, but it's unlikely. It does change.

25. Q Does the rest of the negotiation also happen by

1 telephone?

2 A No. Once they come back, they affirm it
3 electronically. It's an affirmation to us.

4 Q And the order is also electronic. You said there
5 was a firm offer.

6 A No. When I say firm offer, I mean this is the
7 price. The first one is an indication. I'm asking for an
8 indication of where you're willing to trade at. Then this is
9 the price - on a block desk with a firm, for example,
10 typically the way it works is you call up a block - somebody
11 wants to trade 100,000 shares of stock, so they'll call
12 around a couple of block desks and say listen, I'm a buyer of
13 IBM in size at this price. Come back to me with what you're
14 willing to trade, and then they all scurry around and have a
15 meeting amongst themselves, depending on the firm. They then
16 come back to the person who's trying to do the trade and say
17 it will come at this price. It might be sizable at this
18 price or more sizable at another price and so on and so
19 forth. Then I say okay, I can't buy it. I get back in the
20 room, nobody wants to trade at that price. You go back and
21 you raise the price. Eventually this is the price based on
22 what they're indicating on. What they're telling you is not
23 firm either at that time. It's only firm when they actually
24 come back and affirm they were willing to trade at that
25 price.

1 Q So up to the point when they basically accept the
2 offer, --

3 A There is nothing firm.

4 Q And that's the only part of the negotiations that
5 are electronic.

6 A Right.

7 Q Before that it's all by phone.

8 A Right.

9 Q And you're the person who conducts that.

10 A Right.

11 Q Now you mentioned that there was a group of dealers
12 to whom you put out this indication of interest each time.
13 Generally, with how many of them do you end up trading in
14 each execution?

15 A Within the basket, we're probably interacting with
16 40, close to 50.

17 Q That's for equities and options.

18 A Equities. Options is a dozen.

19 Q A dozen. Do all of them end up trading usually?

20 A Pretty much. They all trade on a - yes. It's
21 usually that they all participate during the trading. They
22 have an interest in these stocks. These stocks are the
23 marketplace.

24 Q You mentioned that you generally want to do the
25 options trade all at one price. Is that correct?

1 A Uh-huh.

2 Q Why is that?

3 A Because it's not something, very hard for us to
4 allocate, who gets what at what price and so on. You want to
5 be able to do the whole deal at one price. That's the way
6 you want to hedge it. You normally do it at one price.

7 On the equity side, it's different. It just trades
8 differently. The equity trades are being done at various
9 prices, and there's an average price determined of whatever
10 the total amount of stocks that we bought, but on the options
11 side, you want one price, and it's easier just to do it for
12 everybody at the same price, so you're paying the same price
13 for each individual client. They're all getting one price on
14 the trade. That's typically the way it's done.

15 Q And is there any mark up or mark down between the
16 price that's between the dealer on the options and --

17 A No, no. They charge a penny a share to me, and I
18 pay a penny share. I'm really not performing any great
19 expertise. We basically make our money on the \$.04 a share.

20 Q And the options are over-the-counter options.

21 A Yes.

22 Q What is the rationale for going to the over-the-
23 counter market rather than the Exchange?

24 A Everybody goes to the over-the-counter market on
25 options. That's the way the market is. The over-the-counter

1 market is just really the institutional -- that's the
2 marketplace. I mean you can trade on the floor, you could.
3 Then you'd be trading during the U.S. hours which you don't
4 want to do and you don't want to -- there's really not the
5 liquidity in the option market. It's improving, but it's not
6 where you would want to go.

7 Q Is there any price advantage to be in the over-the-
8 counter market versus the Exchange?

9 A No. Well, when you're doing this kind of size,
10 wherever you buy - it's not like you're executing, you're
11 buying 10 contracts and 20 contracts and so on. In this kind
12 of a market, you're negotiating a price, and you want to get
13 it done, and you don't really care whether you could buy 10
14 contracts or 50 contracts at a better price and so on. It's
15 not something that's an issue to you.

16 Q Who are the counterparties to the options
17 contracts?

18 A They're basically European banks.

19 Q I just want to make sure I understand all the
20 participants. You said you contact these approximately 12
21 dealers. The banks are the counterparties. What is their
22 relationship with those dealers, or is it the same --

23 A The same person.

24 Q So basically, for instance, if you contact a bank,
25 you say I want to buy X number --

1 A - at that price, yes.

2 Q And they're the ones who are the other side to the
3 transaction.

4 A Right.

5 Q Do you have any understanding of, you know, how
6 that transaction fits into their business. Do you have any
7 understanding of what they do with those positions?

8 A You never know what a dealer is doing on the other
9 side, nor do you really care. It's just not something you
10 would ask them. It's not something that I think everybody
11 would have a different reason to do what they want to do.

12 Q We discussed the equities, but the same question
13 with the options. Why foreign dealers rather than U.S.?

14 A Because I'm dealing with their time zone, and
15 that's where my contacts are with. Most of them happen to be
16 the big derivative dealers anyhow.

17 Q You said you're dealing in their time zone.

18 A I'm dealing before the U.S. markets are open.

19 Q So how does the time frame for the options trading
20 relate to the time frame for the equities trading?

21 A First we're putting the equity basket on, and then
22 we're putting the options on after the equity basket is
23 complete, so the options are being done basically in the
24 morning typically between 8:00 and 9:00 a.m.

25 Q Since the equities you mentioned may take a couple

1 of days, do you actually receive options after everything is
2 done on --

3 A No. Each basket -- on Monday we bought a basket.
4 We're going to hedge that basket to the options. Tuesday
5 would be the next piece and so on.

6 Q With the options trades, is there any documentation
7 generated? For example, for some derivatives, there is an
8 after agreement and you have a confirmation, a 2-page
9 document. Is there something like that for the options
10 trades?

11 A Yes, there's an affirmation that's generated
12 electronically, and there's a master option agreement that's
13 attached to that that's also electronic.

14 Q And the electronic affirmation stores data for each
15 trade with each particular dealer.

16 A Correct.

17 Q So if you wanted to find out with whom you bought
18 these contracts on a particular day, that's where you would
19 go.

20 A Right.

21 MS. SUH: We've been going for awhile. Let's go
22 off the record at 12:20 p.m.

23 (Whereupon a luncheon recess was taken.)

24 MS. SUH: Back on the record at 1:06 p.m.

25 Q Mr. Madoff, during the break, did you have any

1 read, if it keeps its standing, the bloom is off the rose in
2 that area, and again it's like lots of businesses that I
3 don't go into. It's just not something that we want to do,
4 and it works well for us. Leave me alone, and I'll leave you
5 alone.

6 BY MS. SUH:

7 Q You mentioned the returns, that they're not high
8 enough to justify setting up a hedge fund. They also are
9 remarkably consistent. They're fairly -- they have low
10 volatility, and there are fairly few periods when they're
11 down. I'm sure you're aware of people wondering how can this
12 happen? What's your answer to that?

13 A Well, let me just say that I pay no attention to
14 what other people say or try to figure out because I've been
15 in this business for a long period of time, and I've learned
16 that everybody goes through, everybody is always busy trying
17 to figure out what everybody else is doing and how they do
18 it, and the only people that do that are the people that
19 don't know what they're doing quite frankly, so a lot of us
20 in the trading community sit around at times and laugh about
21 these types of questions, about how anybody does anything.

22 If somebody understood the strategy, when somebody
23 says it has low volatility, how come, you'd say because
24 that's what the strategy is, to have low volatility. You
25 can't have -- there's no free lunch anywhere, so that if you

1 have a strategy that has a maximum return of let's say in
2 today's environment mid-teens if everything went great, and
3 you had the opportunity to lose a lot of money frequently,
4 there would be something wrong with the strategy. If you had
5 a strategy that isn't hedged, then you would say to yourself
6 it's unusual to have volatility. I'll give you an example.
7 There's stupidity out there. There was an article written
8 years ago about this strategy. I remember the lady that
9 wrote it who was fired from Barons or wherever it was. She
10 did a number of stupid articles. The issues that were, the
11 things that were mentioned in there was that, about being low
12 volatility, lots of things in there. She got it from some
13 other article, and she totally misquoted, but the point is
14 they compared it to a fund called Gateway. Gateway is a fund
15 that does a similar strategy in that they use the whole S&P
16 500 as their product, and sometimes they buy puts.
17 Sometimes. When they do buy puts, they only buy it on part
18 of the portfolio. While their returns on the upside were
19 similar to what our returns were at that time, they had much
20 more money, but she failed to mention that they don't buy
21 puts on the whole strategy. All you do is look at what their
22 strategy. If you only hedge part of the time you're in the
23 market, you're going to have volatility on the downside.

24 If you look at any good market neutral, a term I'm
25 using because people use market neutral for this type of

1 strategy, it's almost like an oxymoron to a certain extent,
2 is that they have low volatility. The more riskier strategy,
3 there's a huge strategy. It is not -- anybody that
4 understood the strategy understands that there would be very
5 low volatility on the strategy. It's not unusual. It would
6 be unusual for it not to. If we had returns, 5% one month
7 and had no down months, that would be unusual. Anybody that
8 understands the strategy doesn't - people have made comments
9 about that, they don't see the strategy. They understand
10 what it is in basic concept. They have no idea. They
11 probably have never seen any of the trades. The only ones
12 that see that are the managers. The investors know the basic
13 concepts. I don't think they actually see what the trades
14 are. They know the stocks I guess. If you're looking at it
15 by looking at quarterly results or even monthly results, it's
16 different. If you look at daily results, you would see lots
17 of volatility. It's like looking at the market and saying
18 the market was flat today. I guess nothing happened. That
19 market could have been up 50 points, down 50 points every 15
20 minutes, and my trades were like this. Throughout the day,
21 it looks like the market did nothing during the day. It is
22 absolutely not surprising, the performance and the strategy
23 is what you would expect it to be if you understood the
24 parameters of the strategy, and that's all I can tell you,
25 but any academic that looked at it would tell you that. It's

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1 Q What is it?

2 A It's a response to a request that you made of
3 various accounts that the firm executes and sells trades
4 through.

5 Q I'd like to go over this list and have you explain
6 in a little more detail the function of each account. The
7 first account on the list, Madoff Investment Securities LLC
8 (ph.). What function does this account have in the
9 institutional trading process?

10 A That's the account that the executions go through
11 for the clients.

12 Q Do any other transactions besides institutional
13 trading go through this account?

14 A No.

15 Q The account, Depository Trust Clearing Corporation,
16 what is the function of this account?

17 A That's the general clearance account for the firm
18 that handles all the settlements of transactions for the
19 firm.

20 Q So this account handles the clearings of all --

21 A -- all.

22 Q -- for the firm. Is there any segregation of that
23 account into sub-accounts or some other segregation where you
24 separate the institutional trading transactions from other
25 firm transactions?

1 A Yes. The institutional accounts are separate from
2 the firm's accounts.

3 Q So DTC, how is that segregated? Under sub-
4 accounts, within 0646?

5 A No, it's just the one account for benefit of
6 clients.

7 Q I guess I'm having trouble understanding because my
8 understanding is there is one account at DTC in the name of
9 your firm.

10 A Right.

11 Q And it's Account 0646.

12 A Right.

13 Q And all kinds of transactions go through it. If
14 you wanted to look at that account and see which of those
15 transactions are institutional trading and which are not --

16 A It's --

17 Q --

18 A -- total of whether the stock is held --

19 Q Can you repeat that? The code for whether --

20 A There are codes that are attached to the activity
21 that say whether it's, whether it's held for the firm or
22 whether it's held in seg.

23 MS. CHEUNG: What do you mean when you say in seg?
24 You mean in segregated?

25 THE WITNESS: Segregated.

1 MR. LAMORE: And it's not --

2 THE WITNESS: No.

3 Q Do you remember what these codes are?

4 A No.

5 Q But DTC would know.

6 A Yes.

7 Q And what kind of reports does the firm get from DTC
8 on the transactions in this account?

9 A Everything gets generated online to the firm on a
10 daily basis. That's the way DTC works now. As a clearing
11 corporation, you get data on everything, the transactions and
12 all that sort of stuff.

13 Q And in the DTC account, the activity that's in the
14 segregated account, that's solely institutional trading
15 business and solely what's perceived as the strategy we've
16 been discussing.

17 A Right.

18 Q The next is the Bank of New York account. What is
19 the function of that account?

20 A It works in conjunction with DTC. It's a
21 settlement account, where we settle our trades, the net
22 difference between the purchases and sells during the day.

23 Q And again, this account is for all firm activity.

24 A Yes.

25 Q And similarly to the DTC, is there a segregation

1 there?

2 A No. There's no segregation on that.

3 Q Okay, and finally the Barclays Capital account,
4 what is its function?

5 A Barclays Capital actually clears and sells trades
6 for Madoff London, and they do currency conversion trades for
7 them and for us when we do our transactions as well.

8 Q And actually to be clear, the DTC accounts are in
9 the name of the New York office.

10 A Right.

11 Q Just to go back to the options issue, the options
12 positions, are they also in the name of the New York --

13 A Correct.

14 (Pause.)

15 Q I'd like to show you what's been previously marked
16 as Commission Exhibit 7. Please review the document, and let
17 me know if you recognize it.

18 A I do.

19 Q What is it?

20 A It's a trading authorization directive that
21 basically lays out the parameters of the transactions for the
22 client.

23 Q How is created?

24 A How is it created? I drew it up.

25 Q So you drafted this.

1 THE WITNESS: Yes, I don't know what happened to
2 it. Yes.

3 Q Unfortunately it got a little smudged in the --

4 A Yes, that's my signature.

5 Q And I just want to go back to the list of accounts
6 that's on the second page of Exhibit 19 which is the letter
7 of May 15th. Other than the accounts listed on this page, an
8 account of Greenwich Century Partners that you pointed out in
9 your letter of May 16th, Exhibit 20, are there any other
10 accounts in the institutional trading business?

11 A No.

12 Q Are there any other accounts for which you trade
13 the split strike conversion strategy that we've been
14 discussing?

15 A No.

16 Q Are there any other accounts in addition to the
17 ones listed in Exhibit 19 and the one pointed out in Exhibit
18 20 where you trade customers' funds pursuant to some trading
19 strategy?

20 A I'm sorry, what?

21 Q Are there any other accounts, basically, where the
22 firm trades for that customer pursuant to that strategy?

23 A No.

24 BY MS. BACHENHEIMER:

25 Q Mr. Madoff, do you personally trade money for

1 anybody else?

2 A What do you mean trade money for anybody else?

3 Q Is there anybody else who provides you capital to
4 invest and you trade on their behalf, whether it be an
5 individual, an entity, a partnership, a corporation, your
6 neighbor, anything or anyone?

7 A We trade, as part of our market making strategy, we
8 get non-held orders. That we trade. We have - there are
9 some individual accounts, family accounts and friends that we
10 trade as well. Is that what you mean?

11 Q Yes. I don't mean - putting aside the market
12 making business and putting aside the proprietary trading,
13 but family, any kind of money that you trade pursuant to any
14 strategy?

15 A Yes. Not institutional funds.

16 Q Is it possible for you to name those individuals,
17 and if not, we ask that you subsequently provide us with a
18 letter with the names of all the individuals or entities that
19 you or the firm trade for that are not part of the market
20 making or the proprietary business.

21 A Okay.

22 BY MS. SUH:

23 Q Do you recall an examination conducted by our staff
24 last summer of your firm?

25 A Yes.

1 Q Do you recall discussing the institutional trading
2 business with Mr. Lamore?

3 A Yes.

4 Q Do you recall telling Mr. Lamore in substance that
5 because of the complexity of incorporating options into the
6 investment strategy or the institutional trading business,
7 you stopped utilizing options as of January 1, 2004?

8 A I said that the -- what --

9 Q Do you recall telling Peter that as of January 1,
10 2004 you no longer incorporated options into the strategy for
11 the institutional trading business?

12 A I said they're not part of the model. The options
13 are not deemed to be part of the model. I did not say, my
14 recollection certainly is not that I said that the accounts
15 don't use options any more to trade. I said the options,
16 that the options were taken out of the model, and they're not
17 part of the model any longer.

18 Q So what change were you referencing in that
19 statement?

20 A Well, they used to be part of the model. As a
21 matter of fact, the change in the trading authorization
22 directive, originally it had the options as part of the
23 model. We consider the model our intellectual property. It
24 states so I believe in the trading authorization directive.
25 We determined that Number 1, the model, we would never be

*Lying
during
exam*

1 able to defend the fact that the parameters of the option
2 trade, there wasn't enough meat on them there where they
3 would be able to be deemed our intellectual property, so we
4 took it basically out of the model and treated them
5 separately.

6 Q You say you took it out of the model. Are you
7 referring to some change in technology?

8 A Yes. There was technology in the model that they
9 were combined, that looked at option information and
10 transaction as well as looking at equity transactions, and we
11 determined that Number 1, the readings we got from the model
12 that related to the options were not significant enough and
13 that unique enough, so we didn't think that should be part of
14 the model, and we let the model stand on its own and the
15 equity side of the options basically stand on its side. I
16 believe we changed the directives so that it was not part of
17 the model.

18 Q Do you recall telling Mr. Lamore in substance that
19 since that change, as of January 1, 2004, the clients may
20 hedge the strategy themselves but that you did not discuss or
21 provide any guidance to clients for hedging the strategy?

22 A No.

23 Q You do not recall making that statement?

24 A I recall saying what I just said, that they were
25 part of the model, that they were no longer part of the

1 model, but I remember specifically saying that the options
2 are still used to hedge the transactions.

3 Q When you say the model, are you referring to MA-
4 206, or what do you mean by the model?

5 A Well, the original trading directive that we had
6 had language in it that included the options as well as the
7 model as well as the equity side of it. We determined to
8 take that tout of it and let the model stand just for the
9 equities of itself, and the option was a separate piece of
10 terms and conditions on the model, and we had always been
11 talking about the model, MA-206.

12 Q So prior to this change, I guess can you describe
13 how the model worked? The model we discussed so far was the
14 model that creates the equities order.

15 A It still is, right.

16 Q What did it used to be when it actually
17 incorporated the options component?

18 A It also had readings on the options as well, so
19 when it was looking at all of the transactions, the model
20 itself that we used for the equity side, MA-206, incorporated
21 option information into it as well. We looked at both pieces
22 of that together as one, as the model, and then we made a
23 decision that the intellectual property which we were
24 defending in the model as ours at that time was okay but not
25 to stand on its - the information the model generated in