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MEMORANDUM

TO: Madoff File

FROM: John Walsh

Personal Privacy

Personal Privacy

Office of Compliance Inspections and Examinations

RE: Bernard L. Madoff Investment Securities

We have been asked to prepare a timeline showing examination activity in relation to Bernard L. Madoff Investment Securities (the "Madoff firm"). The information provided below comes from multiple sources and is believed to be accurate. This chronology covers only examinations, and other agency operations to the extent they are essential to understand the examination chronology.

The chronology covers the thirteen years preceding the current examination. Information is given about the current examination only to the extent necessary to help put prior information in context. The review period has been set at thirteen years, because the Commission's Record Control Schedule, 17 C.F.R. 200.80f, sets the holding period for examination records, reports and workpapers, at thirteen years. We have obtained and reviewed the examination reports for all examinations within the last thirteen years (since December 1995). We have either obtained or requested the workpapers for those examinations. In addition, we have requested information on earlier examinations from OIT and the Archivist of the Commission. While retention of records relating to earlier examinations is outside the scope of the agency's record retention period, we will continue to seek to obtain them.

Following the initiative of an investigation by the Commission's Inspector General, we ceased working on this chronology. We provided an advance copy of the following email to the Office of Inspector General, and after receiving their approval we forwarded it to all staff we had identified as having worked on a Madoff-related examination. At that point we ceased work on this chronology. The email read:

Dear [OCIE and NYRO Examination Staffer identified as having worked on a Madoff exam]

Thank you very much for your assistance over the last week in preparing a chronology of events and gathering records relating to examinations of the Madoff firm. Through everyone's hard work we have been able to identify the examinations that were conducted of the Madoff firm, prepare a general chronology of events, and begin locating and gathering relevant records. Your assistance is appreciated.

Now that the Chairman has asked the Commission's Inspector General to investigate this matter, we will defer all fact finding and analysis to him. Please consult with the Inspector General or his staff before you discuss this matter with anyone on or off the staff.

We may continue to contact you regarding the preservation and collection of records to provide to the Inspector General and his staff. In that regard, thank you for your continuing assistance.

Regards

John

We should note that in his directive to the staff that began this review, the Chairman indicated that he wanted to staff to identify and review all Madoff-related activities going back to the firm's original registration as a broker-dealer in 1960. Because the staff stopped the review at this point in time, we were unable to fully implement the Chairman's directive.

Background

The Madoff firm is dually registered as a broker-dealer and an investment adviser. It has been registered as a broker-dealer since 1960, and a registered investment adviser since September 2006. While the firm's broker-dealer activities have been examined in the ordinary course of SEC and self-regulatory oversight, the firm's investment advisory activities, which are the focus of apparently fraudulent acts by Bernard Madoff, had never been examined; the first examination of the firm's advisory operations was initiated on December 11, 2008.¹

Based on information included in examination reports, the Madoff firm has been a member of the NASD since March 25, 1960. The firm is also a member of other self-regulatory organizations and SIPC. The firm is currently organized as an LLC and is almost wholly-owned by its principal, Mr. Bernard L. Madoff and members of his family. The firm is primarily self-clearing. Many of the positions with the Madoff firm, including legal and compliance, were staffed by relatives of Bernard Madoff. The Madoff firm does not have an internal audit department. Any internal audits were conducted by the firm's own back office personnel. Press reports have indicated that the firm's outside auditor is a small and relatively unknown firm.

¹ OCIE examines a small percentage of registered advisers on a routine cycle. Only advisers assessed as "high risk" based on their ADV filings and exam history are examined periodically (every three years). Other advisers are not examined routinely and may only be examined for cause, randomly or as part of a sweep. Advisers are assessed as "high risk" based on, among other factors, the size of assets under management, types of clients, and disciplinary history. The Madoff firm did not report having significant assets under management (relative to other advisory firms), did not report that it managed retail customer accounts or any disciplinary history, and it was thus not classified as "high risk" for scheduling periodic examinations. The Madoff firm's advisory business was classified "medium risk."

The broker-dealer business of the Madoff firm was purportedly based on market making and execution services for hedge funds. The firm gathered billions of dollars of assets from approximately 23 hedge funds, although it now appears there may also have been thousands of individual clients. Bernard Madoff does not hold himself out to be a hedge fund manager, and does not advertise himself as such. During past examinations he indicated that he considers the hedge funds or funds of hedge funds serviced by the firm to be solely broker-dealer customer accounts over which he has trading authority and from which he receives commission income of 4 cents per share per trade.

The Madoff firm is affiliated with Madoff Securities International Limited (“MSIL”), a proprietary trading firm located in London that trades primarily European equities. According to Bernard Madoff, although he has provided MSIL with its capital, the management and operations of MSIL are completely separate from the Madoff firm. MSIL is regulated by the United Kingdom’s Financial Services Authority (“FSA”).

The investment advisory business of the Madoff firm appears to have been handled separately and very secretively by Bernard Madoff and Mr. Frank Di Pascali. It was carefully segregated from market making and other operations of the firm. Indeed, several employees have described the advisory operations as a “firm within the firm.” This segregation was both physical and in its accounting, as described below.

With respect to the physical segregation: the advisory business was conducted on part of the 17th floor, while the rest of the firm’s operations were on other floors. Bernard Madoff and Mr. Di Pascali appear to have controlled access to that part of the 17th floor and severely limited access by other employees. Employees in other parts of the firm have indicated that they were not aware of the activities on portion of that floor.

With respect to accounting segregation: customer securities positions and custodial arrangements for the advisory business were maintained in a separate stock record. This is a large record, filling seven binders with thousands of positions. In light of our review over the last two days, we are concerned that many or possibly all of these positions do not exist. In light of the examination findings made in the current examination, the Staff is concerned that examiners were likely previously provided with incomplete and possibly falsified records and false information to help conceal the fraud.

Examinations before 2008

1997-1998 examination of limit order display. In 1997, the Staff conducted an inspection of the order handling practices at certain so-called “third market firms” that executed retail order flow in exchange-listed securities received from other broker-dealers. The purpose of this special inspection was to evaluate the execution quality of retail orders executed in the third market in light of the Commission’s 1996 order handling rules emphasizing the duty of best execution. The Staff reviewed execution quality of each firm’s order handling operations, including the likelihood of price improvement and executions inferior to the national best bid or offer (“NBBO”), and trading ahead of

customer market orders. In addition, the Staff examined each firm's trade reporting practices for compliance with NASD rules. Eight third market makers were selected, including Bernard L. Madoff Investments ("Madoff"). Madoff provided the Staff with a very substantial electronic file that recorded detailed order entry and execution information, including the NBBO at the time of order entry, and again at execution. This facilitated a more extensive review of order handling activity at Madoff than was possible with the records provided by the other firms. The inspection resulted in findings with regard to several of the firms. With respect to Madoff, the Staff's primary finding was that 110 market orders (2.0% of a sample) were executed by Madoff at prices inferior to the NBBO at order execution time, usually because of manual execution. The Staff warned Madoff that this raised best execution concerns, and could inflate Madoff's price improvement statistics. The Staff advised Madoff to make available to its broker-dealer customers any relevant execution practices that could affect price improvement statistics or execution quality.

1999 examination of limit order display. In late 1999 the headquarters examination Staff in the OCIE simultaneously opened limited scope examinations of the Madoff firm and two other firms to review their practices in regards to the display of limit orders. At that point in time, Madoff was registered solely as a broker-dealer. The examination was conducted from late 1999 to early 2000. In August 2000, the results of all three examinations, including that of the Madoff firm, were discussed with the Division of Enforcement. The Staff was concerned because it had found limit order display rule violations. In these consultations with Enforcement, it was determined that the violations should be resolved through a deficiency letter. In response to the Staff's deficiency letter, Madoff outlined the policies and procedures the firm had implemented to address the limit order display rule violations.

2003 collection of information. In 2003 the staff appears to have collected information from the Madoff firm. We believe this was part of a general review of QQQ trading that included three stock exchanges and two other entities, one of which was the Madoff firm. Request letters were sent to all entities. However, during the course of that review, allegations of widespread trading ahead on multiple markets came to light. The QQQ review was folded into a broader review of the NYSE and regional exchanges for alleged specialist trading ahead and interpositioning activity and of certain Nasdaq market-makers for potential trading ahead of customer order flow. The review of the NYSE and regional stock exchanges began in late 2003 and included the three stock exchanges that were initially part of the QQQ review. The broad review of order handling by Nasdaq market-makers began in January 2004 but had a slightly different focus (executions at the bid/offer of orders at the market open versus single price executions) since NASD did not have a similar rule to the NYSE's dealing with trading ahead and interpositioning activity. The reviews focused on best execution and order handling with respect to retail order flow and did not include the Madoff firm as it did not appear at that time to receive significant retail order flow and offered a single price execution at the market open. Some members of the staff have indicated that they vaguely recall working on a Madoff matter in 2003, but they are uncertain as to its subject matter. We believe these were likely the QQQ review.

2004 examination of possible front running. In 2004 the headquarters examination Staff in the OCIE opened a limited scope examination of the Madoff firm. Again, at that point in time the firm was registered solely as a broker-dealer. The examination reviewed allegations that the firm was front running client trades to the benefit of its hedge fund clients. The Staff did not find any evidence of front running. The examination was conducted during 2004. In 2005 OCIE referred its work to the examination Staff in the New York Regional Office ("NYRO") for inclusion in a review conducted by that office based on similar allegations. NYRO's review is discussed immediately below.

2005 examination of cherry picking and front running. In 2005 the NYRO conducted a limited scope cause examination of the Madoff firm that focused on allegations which had been found in e-mails discovered by the NYRO's Investment Adviser #1 examination Staff while conducting a 2004 examination of another firm [REDACTED]

These e-mails expressed suspicions that Madoff cherry-picked trades for the hedge fund, and that his executions were highly unusual. Also, articles in the press questioned the firm's apparent ability to generate consistently positive returns for its clients with minimal volatility.

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The NYRO cause examination focused on these issues and on understanding Madoff's trading strategy for the hedge fund customers. In particular, it focused on whether the firm was using non-public customer order flow information to benefit the firm's proprietary algorithmic trading. Examiners reviewed the Madoff firm's trading strategy using front-end trading system records and customer statements. At the conclusion of the examination the firm was given a deficiency letter citing a limited number of best execution and inter-positioning violations.

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January 2006 enforcement inquiry. In January 2006, NYRO Enforcement Staff opened an investigation of the Madoff firm based on a complaint letter received initially by the Commission's Boston Office. During the Enforcement staff's preliminary inquiry, they learned from NYRO examiners, that during the recent examination Mr. Madoff did not fully disclose to examiners either the nature of the trading in the hedge fund accounts or the number of accounts. The Staff also found that the Madoff firm had acted as an investment adviser to certain hedge funds, institutions, and high net worth individuals without registering as an investment adviser. The enforcement Staff found no evidence of fraud and the firm voluntarily remedied the registration issue. The investigation was closed in 2007.

SRO examinations. FINRA or its predecessors the NYSE and NASD examined the Madoff firm in 2003, 2005, and 2007. The examinations in 2003 and 2005 were filed without action, citing no violations. In the 2007 examination, which was a full-scope routine examination, FINRA found an apparent de minimus net capital computation violation and that the firm failed to timely report certain TRACE transactions. The report of FINRA's 2007 examination also indicates that the firm had no customers, including no investment adviser customers. The Madoff firm had registered as an investment adviser in September 2006, and had disclosed in its Form ADV that it had 23 -24 investment

adviser clients and several billion dollars in assets under management. In a conference call between OCIE and FINRA staff the FINRA staff indicated that their examiners had not reviewed the form ADV, and were reluctant to do so due to concerns that too close review of the advisor operations could appear to trespass in operations not subject to FINRA's oversight.

In light of the examination findings made during the current examination, see below, the Staff is concerned that during some or all of these examinations, examiners were likely provided with incomplete and possibly falsified records and false information in order to help conceal the fraud.

The Current Examination .

The New York Regional Office initiated a cause examination of the Madoff firm on December 11, 2008, following a tip from counsel for Bernard Madoff's sons. On Wednesday, December 10, 2008, counsel for Bernard Madoff's sons contacted Andrew Calamari, NYRO's Enforcement Associate Regional Director, to report that Bernard Madoff had confessed to his sons that the Madoff business "was a \$50 billion Ponzi scheme." That same day, Andrew Calamari contacted the U.S. Attorneys Office as well as senior managers within OCIE and the NYRO examination program to apprise them of the situation.

The NYRO immediately opened a cause examination and sent an examination team composed of both broker-dealer and adviser examiners to the firm's offices at around 9:00 a.m. on December 11, 2008.

Law Enforcement

Also during December 11, 2008, the Staff interviewed an employee who seems to be involved in the broker-dealer's back office operations. The employee was somewhat helpful. Following extensive interviews by the Staff, the employee provided the Staff with information about a Chase bank account, and told the Staff: "Here are all the secrets." Upon review it appears that large sums flowed through this account, including many checks written to what appear to be retail customers.

On the morning of December 12, 2008, NYRO Staff interviewed MSIL (London) employees. The MSIL employees indicated that their business was strictly proprietary trading, that they performed no other services for the Madoff firm, including specifically that they provided no custodial services.

The Staff has also reviewed the binders containing advisory clients' securities positions. The Staff determined that the locations for these positions were uniformly given as "Clearing Banks." To date, the Staff has been unable to identify any such clearing banks.

The adviser's ADV disclosed that it managed approximately 23 individual accounts. However, based on the Staff's review during the last two days it appears that the number of individually managed accounts may run into the thousands. This would be consistent with the activity in the Chase account revealed by the operational employee. The Staff first learned of these accounts during the current on-site review.

The examination is ongoing and the examination team continues to make follow-up document requests and conduct on site interviews as necessary and appropriate to complete their examination.