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Office of Audits

Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities, LLC



September 29, 2009
Report No. 468



OFFICE OF
INSPECTOR GENERAL

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

MEMORANDUM

September 29, 2009

To: Mary L. Schapiro, Chairman
John H. Walsh, Acting Director, Office of Compliance Inspections
and Examinations

From: H. David Kotz, Inspector General, Office of Inspector General (OIG) 

Subject: *Review and Analysis of OCIE Examinations of Bernard L. Madoff
Investment Securities, LLC, Report No. 468*

This memorandum transmits the U.S. Securities and Exchange Commission, OIG's final report detailing the results of the review conducted by FTI Consulting, Inc. of the Office of Compliance Inspections and Examinations (OCIE) examinations of Bernard L. Madoff and Bernard L. Madoff Investment Securities, LLC. The review was conducted as part of the OIG's continuous efforts to assess management of the Commission's programs and operations.

OCIE concurred with the report's 37 recommendations. Based on the written comments that were received and our assessment of the comments, we revised the report accordingly.

Within the next 45 days, please provide OIG with a written corrective action plan that is designed to address the agreed upon recommendations. The corrective action plan should include information such as the responsible official/point of contact, time frames for completing the required actions, milestone dates identifying how you will address the recommendations cited in this report, etc.

Should you have any questions regarding this report, please do not hesitate to contact me. We appreciate the courtesy and cooperation that you and your staff extended to our contractor.

Attachment

cc: Kayla J. Gillan, Deputy Chief of Staff, Office of the Chairman
Diego Ruiz, Executive Director, Office of the Executive Director

Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities, LLC

Executive Summary

Background. On June 25, 2009, the Securities and Exchange Commission's ("SEC" or "Commission") Office of Inspector General ("OIG") retained the services of a team of experts at FTI Consulting, Inc. ("FTI Engagement Team") to assess the adequacy of examinations conducted by the SEC's Office of Compliance Inspections and Examinations ("OCIE") in response to complaints regarding the activities of Bernard L. Madoff ("Madoff") and his investment firm, Bernard L. Madoff Investment Securities, LLC ("BMIS").

Objectives. The FTI Engagement Team reviewed the OIG's Report of Investigation dated August 31, 2009, including related findings, exhibits, witness testimony and supporting documentation, and analyzed the workpapers from OCIE's examinations of Madoff, OCIE's manuals, OCIE's guidance documents and policies, and other governmental and private reports relating to examination programs. In addition, the FTI Engagement Team interviewed over a dozen key OCIE managers and staff to gain an understanding of the OCIE examination process.

Results. The FTI Engagement Team found that OCIE examiners made critical mistakes in nearly every aspect of their examinations of Madoff and BMIS and missed significant opportunities to uncover Madoff's Ponzi scheme. The FTI Engagement Team concluded that OCIE examiners did not properly plan or conduct their examinations of Madoff, and because of these failures, were unable to discover Madoff's fraud.

The following is a summary of many of the specific findings in this report. The FTI Engagement Team found that OCIE did not properly evaluate the information provided in 2001 news articles that raised significant red flags about Madoff's operations. The FTI Engagement Team explained that information received relating to a potential violation must be properly vetted and opined that in the case of the 2001 articles about Madoff, there was sufficient detail in these articles to warrant additional scrutiny due to the red flags raised.

The FTI Engagement Team further found that OCIE did not properly evaluate a complaint in 2003 and a referral in 2004 from highly credible sources that provided specific and concrete information about the possibility of Madoff not engaging in trading. The review found that given the credibility of the information triggering the examinations, the significant delays before the examinations

commenced were unreasonably long, there was insufficient review of the complaints, and the cause examinations failed to address critical issues raised in the complaints. The review found that, at the time, OCIE had no formal policies or procedures for handling tips and complaints in place which led to their mishandling of the information.

The FTI Engagement Team also found that the planning memoranda for the OCIE examinations were either inadequate or not drafted at all. The review found that there were no formal policies or procedures at that time that required the preparation of a planning memorandum. The FTI Engagement Team concluded that had the scope of the examinations been adequately analyzed and related to the complaints, the cause examinations would have more closely focused on the possibility of a Ponzi scheme being conducted by Madoff.

The FTI Engagement Team further found that there was inadequate communication and information sharing among OCIE personnel in connection with their examinations of Madoff. In addition, the pre-examination preparation was inadequate, the examination tracking system was not properly used to log the initiation of the cause examinations, and the examiners did not adequately close the examinations. The review found that while OCIE senior personnel had an initial conversation with Madoff concerning the cause examination, there were no policies or procedures in place requiring them to document substantive interviews, and as a result, no clear, contemporaneous record of this and other critical discussions was made. The review also found that OCIE did not have formal policies and procedures requiring the preparation of closing memoranda for examinations.

The FTI Engagement Team found that OCIE did not form appropriate examination teams to conduct the examinations. The review found that one of the examinations lacked a Branch Chief and both teams lacked staff with the expertise necessary to effectively identify signs of fraud. The FTI Engagement Team concluded that the failure to form appropriate examination teams with sufficient expertise must be remedied in order for OCIE to uncover fraud in future cause examinations.

The FTI Engagement Team found that OCIE failed to contact Madoff's clients to corroborate his representations in the examinations even though several of these clients were SEC-registered investment funds who were subject to SEC books and records requirements. The review found that SEC examiners failed to follow-up on numerous contradictions discovered during the examinations and many discrepancies were left unresolved.

The FTI Engagement Team found that OCIE failed to understand how BMIS executed, cleared and settled his purported trades, and these failures contributed to their inability to uncover Madoff's Ponzi scheme. The review found that SEC examiners did not acquire and analyze trading data from an independent source

to verify the trading volume Madoff represented in client account statements, and had such an analysis been conducted, they would have likely discovered Madoff's fictitious trades. The FTI Engagement Team replicated several aspects of the cause examinations of Madoff, and demonstrated how obtaining the pertinent information would have uncovered the fraud.

The FTI Engagement Team also found that the examinations were improperly closed without resolving numerous issues, that one examination team actually believed they might be subjected to legal liability if they contacted Madoff's feeder funds, and that the Madoff examination teams failed entirely to investigate the allegations in two complaints about the lack of independence of Madoff's auditor.

Summary of Recommendations. This report presents 37 specific and concrete recommendations designed to improve nearly every aspect of OCIE's operations. Many of these recommendations are summarized as follows: The FTI Engagement Team recommends that examiners be provided access to industry publications and databases, and protocols be established for analyzing information from these outside sources. The report recommends that OCIE establish a specific protocol that explains how to identify red flags and potential violations of securities laws based on the information gleaned from these sources.

The report further recommends the implementation of a collection system for capturing information in tips and complaints, a requirement that OCIE annually review and test the effectiveness of the new system, and that procedures be put in place to ensure that all OCIE-related tips and complaints are vetted within 30 days of receipt and examinations commence within 60 days of receipt.

The report prescribes specific procedures regarding scope and planning memoranda for cause examinations, including a requirement of concurring review by an unaffiliated senior-level official. The FTI Engagement Team also recommends that OCIE examiners be required to document all substantive interviews, prepare detailed workpapers, and log all examinations into a tracking system. There are also a number of concrete recommendations regarding the selection of the examination team.

The report recommends the development of a formal plan to ensure that within a three-year period, 50% of OCIE staff become qualified by means of an industry certification to conduct thorough and comprehensive examinations. The report also recommends the development of interactive exercises prior to hiring new OCIE examiners to evaluate the relevant skills necessary to perform examinations. Moreover, the report makes recommendations for training of OCIE examiners in the mechanics of securities settlements, and in regulations of foreign and domestic exchanges.

The report also recommends that it be mandatory for the OCIE staff to verify a sample of transactions with an independent third party and that the staff be given direct access to databases maintained by self-regulatory organizations (“SROs”) to allow them to perform verifications of registrant information.

The report further recommends requirements for all cause examinations to be tracked consistently and appropriately and for examinations to be concluded with a closing report. Finally, the report recommends that OCIE management make clear that it will support OCIE examiners in their pursuit of evidence in the course of an examination.

We believe that implementation of all 37 recommendations contained in this report will significantly improve OCIE’s operations and its ability to uncover fraud in the future.

A detailed list of our recommendations can be found in Appendix IV.

OCIE concurred with all 37 of the report’s recommendations. Management’s responses to the report are included in its entirety in Appendix IV. The OIG’s response to Management’s comments is included in Appendix V.

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Background and Objectives

Background

On December 11, 2008, the Securities and Exchange Commission (“SEC” or “Commission”) charged Bernard L. Madoff (“Madoff”) and his investment firm, Bernard L. Madoff Investment Securities LLC (“BMIS”), with securities fraud for a multi-billion dollar Ponzi scheme that he perpetrated on advisory clients of his firm. The complaint charged the defendants with violations of the anti-fraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. In addition, the U.S. Attorney’s Office in the Southern District of New York also indicted Madoff for criminal offenses on the same date. On March 12, 2009, Madoff plead guilty to all charges and on June 29, 2009, federal District Judge Denny Chin sentenced Madoff to serve 150 years in prison, which was the maximum sentence allowed.

By mid-December 2008, the Commission learned that credible and specific allegations regarding Madoff’s financial wrongdoing, going back to at least 1999, were repeatedly brought to the attention of SEC staff, but were never recommended to the Commission for action. As a result, former Chairman Cox requested that the SEC’s Office of Inspector General (“OIG”) conduct a full and immediate investigation of the past allegations regarding Madoff and his firm and the reasons they were not found credible.

On June 25, 2009, FTI Consulting, Inc. (“FTI”) was retained¹ by the OIG to conduct a review to assess the adequacy of the SEC’s Office of Compliance Inspections and Examinations’ (“OCIE”) conduct, primarily with regard to two examinations. The first was the Washington, D.C. OCIE cause examination that was triggered by a submission from a hedge fund manager (hereinafter referred to as the “Hedge Fund Manager’s Complaint”) about Madoff and was conducted principally in 2004 (hereinafter, referred to as the “2004 OCIE Cause Examination”). The second was the examination conducted by the SEC’s Northeast Regional Office (“NERO”) as a result of internal emails they uncovered in connection with a routine examination of an SEC-registered firm, detailing concerns about Madoff’s operations, which was conducted mostly in 2005 (hereinafter, referred to as the “2005 NERO Cause Examination”).²

¹ FTI had been previously retained by the SEC OIG in February 2009 to assist with the OIG’s investigation of OCIE’s examinations of Madoff and thus had the opportunity to review the documents and testimony in connection with the SEC examinations of BMIS and Madoff. Members of the FTI Engagement Team provided expert analysis to the OIG in the preparation of its Report of Investigation.

² As discussed in the OIG Report of Investigation No. 509, OCIE also conducted the following examinations of BMIS since 1992: 1992 cause examination; 1994 special purpose examination;

For this engagement, OIG requested a team of FTI professionals from various disciplines, who are referred to, collectively, as the FTI Engagement Team. (The individual members of the FTI Engagement team are identified and biographies provided on pages 5 – 6 of the OIG’s Report of Investigation dated August 31, 2009). The FTI Engagement Team reviewed the OIG’s Report of Investigation dated August 31, 2009 and also analyzed a number of other relevant sources in order to identify areas of improvement to OCIE’s examination program including, but not limited to, the following: GAO Report to Congress dated August 2007 (“Steps Being Taken to Make Examination Program More Risk-Based and Transparent”); U.S. Chamber of Commerce Report dated February 2009 (“Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission”); and recent submissions from Lori Richards, former Director of OCIE, and John Walsh, Chief Counsel and acting Director of OCIE, to David Kotz. As a result, some of the FTI Engagement Team’s recommendations may include a broader application than the 2004 OCIE Cause Examination and the 2005 NERO Cause Examination; however, such recommendations remain relevant to the goal of improving OCIE’s examination program.

Objectives

The OIG conducted a comprehensive investigation of the OCIE examinations of Madoff and BMIS that were triggered by credible and detailed complaints concerning Madoff’s operations. The OIG issued a 457-page Report of Investigation on August 31, 2009 entitled, “Investigation of Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme.”

In light of these investigative findings, the OIG retained the services of the FTI Engagement Team as experts in the areas of forensic accounting and regulatory examinations to examine and analyze the OCIE workpapers and reports in connection with the OCIE examinations of Madoff and BMIS and review OCIE modules, policies, procedures and guidance associated with the conduct of its examinations. The FTI Engagement Team was also tasked with providing specific and concrete recommendations designed to improve the operations of OCIE based upon its findings in the review.

1995 oversight examination; 1998 inspection of third-market firms; 1999 special purpose examination; and the 2003 QQQ examination, and the FTI Engagement Team reviewed documents and information concerning those examinations as well.

Findings and Recommendations

Finding 1: OCIE Did Not Properly Evaluate in a Timely Manner Red Flags Provided in News Articles From 2001 That Raised Red Flags About Madoff

Two articles published in 2001, one from Barron's entitled "Don't Ask, Don't Tell: Bernie Madoff is so secretive, he even asks his investors to keep mum" and another from MAR/Hedge entitled "Madoff tops charts; skeptics ask how," raised red flags concerning Madoff's returns and trading strategy but were not adequately evaluated by OCIE. OCIE had no formal policy with regard to how it vetted news articles and other industry sources. Moreover, OCIE did not open the 2004 OCIE Cause Examination of BMIS until it received other tips and/or complaints two years later.

The objective of a cause examination is to investigate a potential violation of securities laws. Potential violations come to the attention of OCIE through three principal means:

1. Routine examinations – While conducting a routine examination for one broker-dealer ("BD") or registered investment adviser ("IA"), an examiner may come across information that points to a potential violation at another BD or IA firm.
2. News reports and articles – A journalist may have sources that are sufficiently well-informed, allowing for publication of potential securities law violations at specific firms.
3. Outside Tips or Complaints – Complaints from investors, whistleblowers or market participants may come to the attention of OCIE through any of the SEC's divisions or offices.

Regardless of the source, the information relating to a potential violation (referred to generically as a "complaint," or "tip") must be properly vetted to determine if the information is sufficiently specific to establish the nature of the potential violation and whether the potential violation is severe enough to merit a cause examination. The MAR/Hedge and Barron's articles quoted industry sources and discussed a number of issues, including Madoff's highly unusual market-timing; his unusually consistent, non-volatile returns; and his ability to buy and sell securities without affecting the market. In our opinion, there was sufficient detail

in these articles to warrant additional scrutiny due to the red flags raised.³ However, there is no evidence that OCIE personnel evaluated the merits of the issues raised until receiving additional complaints several years later.

In order for articles and other industry sources to be properly vetted, examiners need access to these sources and also need to understand how to analyze the information contained in them. The FTI Engagement Team understands that OCIE's Office of Risk Assessment currently monitors industry trends and developments, in part, by reviewing industry reports and news articles. OCIE staff also has access to news aggregator products (i.e., Factiva, Dow Jones Interactive), industry specific news services (Ignites, FundFire, etc.) and subscription services such Thomson Research, Bloomberg, Lexis and Westlaw. Notwithstanding the access, however, we found that OCIE did not conduct sufficient review and follow-up of the two articles raising concerns about Madoff's operations.

Recommendation 1:

The Office of Compliance Inspections and Examinations ("OCIE") should provide all examiners access to relevant industry publications (i.e., MAR/Hedge-type publications) and third-party database subscriptions sufficient to develop examination leads and stay current with industry trends. OCIE should regularly (i.e., quarterly) assess whether they have adequate access to relevant industry publications and other such sources (newsletters, independent subscription-type news alerts, etc.) and make reasonable attempts to gain such access.

Recommendation 2:

The Office of Compliance Inspections and Examinations should establish a protocol for searching and screening news articles and information from relevant industry sources that may indicate securities law violations at broker-dealers and investment-advisers. The protocol should include flexible searching capability to help identify specific areas of risk or concern and should include access to all relevant industry publications. The protocol should also include adequate screening criteria to eliminate unnecessary results and/or to more narrowly define a search in order to generate sufficient results. The screening criteria and any changes should be documented and the protocol should be re-assessed regularly (i.e., quarterly) in order to determine if any modifications are appropriate.

³ As the OIG's Report of Investigation dated August 31, 2009 discusses in detail, there is evidence that former Director of OCIE Lori Richards believed that the Barron's article itself was a sufficient basis for an OCIE examination simply based upon her review of the article.

Recommendation 3:

The Office of Compliance Inspections and Examinations (“OCIE”) should establish a protocol that explains how to identify red flags and potential violations of securities law based on an evaluation of information found in news reports and relevant industry sources. The protocol should also determine how decisions on whether to initiate cause examinations are made and by whom, set a reasonable time frame for evaluation (i.e., 90 days) of the search results and provide notification to OCIE management when such time has expired.

Finding 2: OCIE Did Not Properly Evaluate a Credible Complaint From an Industry Source During 2003 That Raised Red Flags About Madoff

A detailed complaint from a highly credible hedge fund manager employed at a SEC-registered fund of hedge funds was provided to OCIE during May 2003 (the “Hedge Fund Manager’s Complaint”). Although the 2004 OCIE cause examination was eventually opened to address alleged front-running activity at Madoff, the cause examination was not opened until six months after the complaint was received and did not address several significant issues and red flags raised in the tip.

The Hedge Fund Manager’s Complaint was based on due diligence investigations it conducted into BMIS during 1998 and 2003. OCIE was familiar with the firm that provided the complaint and had recently conducted an examination of the firm. Testimony by OCIE personnel adjudged the hedge fund manager that provided the complaint to be a highly credible source of information and described his firm as very experienced and technically savvy.

Given the credibility of the 2003 Hedge Fund Manager’s Complaint, the delay of over six months that occurred from the time the complaint was received until the start of the cause examination was an unreasonably long period of time due to the inherent nature of cause examinations. Cause examinations should be initiated as soon as possible based on their urgency and importance. Delays in starting a cause examination may prolong the effects of any illegal conduct, which may increase the potential harm to investors and capital markets. Despite this, the cause examination was not opened until another tip alleging front-

running came to OCIE from the Division of Enforcement during December 2003 (the "Enforcement Tip").⁴

In addition, OCIE had no formal policies and procedures for handling tips and complaints. Such policies and procedures would have provided personnel with discrete guidelines to assist with the analysis and management of processing tips and complaints. Such a system would allow for appropriate personnel to monitor the status of the tips and complaints and could also alert personnel when additional action was needed.

With regard to information from the hedge fund employee, OCIE did not monitor the status of the Hedge Fund Manager's Complaint and it does not appear that anyone within OCIE management took ownership or responsibility for timely resolution of the tip. As a result, the Hedge Fund Manager's Complaint was left inactive for months because there was no system to alert or remind staff that further action needed to be taken.

Once the 2004 OCIE Cause Examination was opened, it did not address several significant issues and red flags raised in the Hedge Fund Manager's Complaint but instead looked at the front running allegations in the Enforcement Tip. In mid-December 2003, OCIE prepared a Planning Memorandum that described the limited scope of its cause examination, which was primarily focused on front-running. Specific allegations and concerns were raised in the Hedge Fund Manager's Complaint were not addressed in the Planning Memorandum.⁵

During January 2004, at least one OCIE manager contacted the hedge fund manager's firm to discuss issues contained in the Hedge Fund Manager's Complaint. OCIE did not have policies and procedures for documenting such conversations with registrants (see Finding 4), and as a result, the identity of all

⁴ The pretext for the Enforcement Tip was likely that Madoff was using customer trading information from his market-making operations (another, presumably legitimate, part of BMIS) to front-run trades for his investment advisory clients and that front running would explain the consistent returns he reported to his investment advisory clients. Front running is an illegal attempt by a broker to insert one trade for the broker's benefit in front of a large trade order received from the broker's customer. The front-running broker hopes to profit from his knowledge that a large order is about to enter the market by taking a position in the stock before the large trade arrives. The front-runner's trade, though, is usually much smaller than the customer order so as not to move stock prices until the larger order is being executed. After the larger order executes, the front-runner will likely liquidate its position immediately.

⁵ Such issues and concerns included Madoff's fee structure; whether or not there was enough market volume to support \$8-10 billion of alleged trading by Madoff; whether or not the returns should have had a noticeable correlation to the overall equity markets; why the accounts held only cash at the end of the month; lack of a third-party broker; reports that the auditor was a related party; lack of independent custodian; and generally, whether or not the purported returns were feasible given the nature of the investment strategy and the large amount of assets purported to be under management. The complaint did not explicitly mention front-running as an issue.

participants and a clear, contemporaneous record of all substantive discussions during the call were not documented. Moreover, examination team members who did not participate in the call may not have been provided important information or details that could have been helpful during the examination. In addition, members of the examination staff indicated that they had not seen the Hedge Fund Manager's Complaint or all of its supporting documentation. Due to the nature of the specific allegations, the cause examination team members were not provided critical information needed to adequately conduct the 2004 OCIE Cause Examination (see Finding 5).

Finding 3: NERO Did Not Properly Evaluate a Credible Complaint From an Industry Source During 2005 That Raised Red Flags About Madoff

A detailed analysis presented in a series of emails from a registered investment adviser came to the attention of NERO during 2004 (the "2004 Complaint"), which resulted in the NERO 2005 Cause Examination of front-running and cherry-picking activity at BMIS. The analysis performed by an employee at the investment adviser concluded that Madoff must have been misrepresenting his trading. However, the cause examination was not opened until eight months after the 2004 Complaint was received and it did not address several significant issues and red flags raised in the complaint.

Similar issues raised in the Hedge Fund Manager's Complaint preceding the 2004 OCIE Cause Examination came to light with regard to the 2004 Complaint discovered by NERO during a SEC examination of a registered investment adviser in 2004. The 2004 Complaint was detailed, viewed as credible by NERO management and deemed worthy of a cause examination. The start of the examination, though, was delayed considerably in order to assign a particular NERO examiner who presumably had a sophisticated knowledge of options trading. However, no attempts were made by NERO to request such expertise from other offices or divisions of the SEC in order to begin the examination sooner.

In addition, NERO examination staff never contacted the investment adviser that was the source of the 2004 Complaint in order to clarify or glean additional insight regarding the issues raised in the complaint. The 2004 Complaint raised a number of issues and concerns with regard to BMIS and its order routing for

trades, consistent returns, fee structure, and auditor independence. The 2004 Complaint also raised additional concerns about Madoff's representations concerning his options trading and his secrecy. Despite the specific concerns raised in the 2004 Complaint, NERO conducted only a narrowly focused examination of Madoff for front-running and cherry-picking activity.⁶ NERO did not prepare a planning memorandum addressing the scope of the examination and the reasons for such a limited scope.

OCIE contends that limited resources may affect examination activity. In the letter dated July 1, 2009 from OCIE to the OIG, Lori Richards explained that there are inherent limitations with regard to matters that can be worked on by examiners: "Given the large number of firms subject to examination oversight by the SEC and the relatively small number of SEC staff examiners, the SEC does not conduct comprehensive examinations, and it does not examine all firms that are registered with SEC. Examiners generally work on a number of examination matters simultaneously, and seek to prioritize the highest-risk firms and issues that most warrant examination." OCIE claims staffing limitations may continue to have a significant impact on OCIE's ability to conduct examinations in the future.

It is the FTI Engagement Team's understanding that the SEC has recently taken steps to improve its ability to handle tips and complaints. In February 2009, the SEC retained the Center for Enterprise Modernization to begin work on a comprehensive review of internal procedures to evaluate tips, complaints, and referrals. The FTI Engagement Team has learned that the project is intended to be significant in scope and has not yet been completed. On August 5, 2009, Robert Khuzami, Director of the Division of Enforcement, announced the creation of an Office of Market Intelligence. The Office of Market Intelligence will be responsible for the collection, analysis, risk-weighting, triage, referral and monitoring of the hundreds of thousands of tips, complaints and referrals that the Commission receives each year.

While the SEC has begun the process of developing policies and procedures to improve the manner in which they evaluate tips and complaints, these procedures, when finalized, need to be tested to ensure that they operate effectively.

Recommendation 4:

In accordance with the findings of the Center for Enterprise Modernization project and prior to its completion, the Office of Compliance Inspections and Examinations ("OCIE") should implement an OCIE-related collection system that adequately captures information relating to the nature and source of each tip or

⁶ Cherry-picking is the illegal practice of improperly allocating losing (or less profitable) trades to one account with winning trades allocated to another.

complaint and also chronicles the vetting process to document why each tip or complaint was or was not acted upon and who made that determination. All OCIE examiners should be given access to the system in order to be able to timely view and monitor tips and complaints that may be relevant to examinations they are preparing to conduct or are actively conducting. In addition, OCIE examiners should be given adequate access to tips and complaints received by the newly-created Office of Market Intelligence and other relevant sources such as the Office of Investor Education and Advocacy.

Recommendation 5:

The Office of Compliance Inspections and Examinations (“OCIE”) should annually review and test the effectiveness of its policies and procedures with regard to its tip and complaint collection system. OCIE should also modify these policies and procedures, where needed.

Recommendation 6:

Tips and complaints reviewed by the Office of Compliance Inspections and Examinations that appear on the surface to be credible and compelling should be probed further by in-depth interviews with the sources to assess their validity and to determine if there are other issues that need to be investigated. Any apparent contradictions in tip or complaint information need to be resolved as early as possible in the examination process through interviews with appropriate sources or further independent research. Findings from such interviews should be adequately documented and should be required reading for examination team members.

Recommendation 7:

All Office of Compliance Inspections and Examinations (“OCIE”) related tips and/or complaints that are not vetted within 30 days of receipt should be brought to the attention of the OCIE Director with an explanation for the delay. All OCIE-related tips and/or complaints that merit a cause examination for which that examination does not begin within 60 days of receipt (a “Post-60 Day Examination”) must be reported to the OCIE Director with a monthly tally of yet-to-be-opened Post-60 Day Examinations sent to the Securities and Exchange Commission Chairman.

Recommendation 8:

All potentially relevant information received by the Office of Compliance Inspections and Examinations from a tip or complaint source should be preserved as a complete unit and should be augmented with relevant information

that may have been provided in subsequent submissions by that source. Once an examination has been initiated, such information should be required reading for examination team members.

Finding 4: NERO Did Not Prepare a Planning Memorandum For the 2005 NERO Cause Examination of Madoff

NERO Did Not Prepare a Planning Memorandum For the 2005 NERO Cause Examination of Madoff. At the time, NERO had no policies and procedures that required the use of a Planning Memorandum.

The 2004 Complaint that triggered the 2005 NERO Cause Examination included highly detailed e-mails discussing a number of issues and concerns with regard to BMIS and its order routing for trades, consistent returns, fee structure, and auditor independence. The 2004 Complaint also raised additional concerns about Madoff's representations concerning his options trading and his secrecy. The examination staff had copies of the MAR/Hedge and Barron's articles, both of which raised similar issues. However, these issues were not included in the apparent scope of the 2005 NERO Cause Examination. At the time, there were no formal policies in OCIE or NERO that required the preparation of a Planning Memorandum. As a result, a Planning Memorandum was never drafted by NERO that explained the focus or explicitly described the scope of its cause examination.

Apparently, the issues raised in the 2004 Complaint were never fully vetted by the examination team and its supervisors. One NERO examiner testified that although they may have reviewed e-mails contained in the complaint, they were never discussed with their supervisors. Another examiner testified that he may have reviewed "snippets" of the emails contained in the 2004 Complaint, but really used the Barron's article and the MAR/Hedge article as a starting point rather than the e-mails. Had the scope of the examination been adequately analyzed and documented, it likely would have resulted in a cause examination more closely focused on the issues raised in the 2004 Complaint.

Finding 5: The OCIE Planning Memorandum Was Inadequate in its Scope and Execution

The OCIE Planning Memorandum in connection with the 2004 OCIE Cause Examination of BMIS was inadequate in

its scope because it did not reflect an appropriate analysis of the Hedge Fund Manager's Complaint that was received by OCIE. The execution of the OCIE Planning Memorandum was also inadequate because the OCIE examination team did not achieve the basic objectives of the memorandum.

The basis for the determination of the focus of the 2004 OCIE Cause Examination lacked an appropriate analysis of the Hedge Fund Manager's Complaint. OCIE management indicated that the Market Oversight/SRO group decided to focus on front-running during the cause examination because that was the group's area of expertise. The decision to focus entirely on front-running was an improper one as the Hedge Fund Manager's Complaint clearly identified other critical issues unrelated to front-running. The Planning Memorandum that was prepared by OCIE was evidence of this overly narrow focus. A review and comparison of the Hedge Fund Manager's Complaint to the Planning Memorandum should have raised questions as to why such significant allegations were not included. In particular, management from OCIE's IA group likely would have recognized issues that were not related to front-running that should have been considered during the cause examination, had they been given an opportunity to review the Planning Memorandum.

Subsequent to the preparation of the Planning Memorandum, at least one OCIE manager had a phone conversation with the individual that provided the Hedge Fund Manager's Complaint. The OCIE manager's notes of that conversation indicate that during the call they discussed several of the concerns relating to BMIS raised in the tip (that were unrelated to front-running), including consistent returns, volume of options trading, whether the strategy is actually executed, and the operating structure of BMIS. Yet, no subsequent revision was made to the Planning Memorandum to address those concerns.

The execution of the narrowly-focused Planning Memorandum was flawed because it included a request to NASD for trading data, but that request was never sent. Data provided by NASD would have allowed OCIE to examine whether or not BMIS was indeed front running its broker-dealer customers. Trading data from NASD, for instance, would have provided (presumed) execution times of trades for BMIS discretionary brokerage accounts, which would be needed to compare to the time of each customer order to determine if Madoff ran trades for his discretionary accounts in front of trades received from customers of the BMIS market making operations. In addition, if the Planning Memorandum had properly provided for investigation of the Hedge Fund Manager's Complaint, the letter to NASD was critical to the review of the tip's trading allegations because the data and information from NASD would have assisted in independently verifying trading activity conducted at BMIS (See Finding 9).

The FTI Engagement Team understands that scope memoranda are now regularly used throughout OCIE for routine and oversight examinations. An OCIE memorandum to all regional offices dated November 25, 2008 announced the implementation of a "...standard examination scope memorandum to be used by the broker-dealer, investment adviser/company, and transfer agent examination staff when conducting routine or oversight examinations." The memorandum further states, "[u]nder this new guidance, a brief scope memorandum (i.e., typically no more than 2-4 pages) should be prepared for broker-dealer examinations, routine investment adviser and investment company examinations, and transfer agent examinations." The procedures require documentation that management approved the selection and scope of each examination. The procedures also allow for a modification of the scope as new information is obtained during the examination and any significant modifications to the scope should be reflected in the examination report.

While scope memoranda are now presumably being utilized in a more formalized manner, these memoranda must be carefully prepared and executed correctly in order to eliminate errors that we found in the 2004 OCIE Cause Examination and 2005 NERO Cause Examination of BMIS.

Recommendation 9:

The Office of Compliance Inspections and Examinations ("OCIE") should augment its policies and procedures related to the use of scope memoranda to better reflect particular consideration given to information collected as the result of tips and complaints that lead to cause examinations. When all potentially relevant tip and complaint source data, background information and research have been collected into one complete unit (see Recommendation 8), examination staff should identify all relevant potential securities law violations and other concerns and then prepare a planning memorandum that ties each and every potential violation and issue into the scoping discussion in the memorandum. The Planning Memorandum should include the basic steps that need to be taken in order to address the issues identified in the scope discussion. The Planning Memorandum should be reviewed, approved and signed (or initialed) by senior OCIE management (i.e., assistant director level or higher) and should include the names of the individuals who prepared and reviewed the document.

Recommendation 10:

The Office of Compliance Inspections and Examinations ("OCIE") should timely modify or append the scope memorandum when significant new facts and issues emerge. The modified or supplemental scoping memorandum should be reviewed, approved and signed (or initialed) by senior OCIE management (i.e.,

assistant director level or higher) and should include the names of the individuals who prepared and reviewed the document.

Recommendation 11:

After examination scoping provisions have been approved, along with all other elements of the Planning Memorandum, the Planning Memorandum should be subjected to concurring review by an unaffiliated OCIE associate or assistant director (“Concurring Director Review”), and the person performing the Concurring Director Review should also recommend additional concurring reviews from the Commission’s Office of Economic Analysis, Office of Chief Accountant or other offices or divisions of the Commission as needed. All concurring reviewers should sign off on the Planning Memorandum indicating their approval and add any comments on the proposed scope or other areas discussed in the memorandum.

Recommendation 12:

After the Planning Memorandum is first drafted, it should be circulated to all examination team members, and all team members should then meet, in person or electronically, to discuss the examination approach and methodology set out in the memorandum, as well as any other issues the team members wish to raise.

Recommendation 13:

The examination team leader should ensure that all steps of the examination methodology, as stated in the Planning Memorandum, are completed and either the team leader or the appropriate team member should sign off on each step as it is completed.

Finding 6: The Communication and Information Sharing Among OCIE Personnel Were Inadequate

The pre-examination preparation that was conducted for the 2004 OCIE and 2005 NERO Cause Examinations was inadequate. The Super Tracking and Reporting System (“STARS”) was not properly used to log the initiation of the cause examinations. OCIE did not provide a closing memorandum or status report on the 2004 OCIE Cause Examination when it provided its examination workpapers to NERO.

OCIE senior personnel held an initial conversation with Madoff concerning its upcoming 2004 OCIE Cause Examination. At the time of the examination, however, OCIE did not have policies and procedures requiring documentation of substantive interviews and pre-examination calls conducted by OCIE of registrants. As a result, the identity of all participants and a clear, contemporaneous record of all substantive discussions during the call were not documented.

The 2004 OCIE Cause Examination team also did not enter its examination into STARS. Market Oversight staff and management at that time regularly did not log new examinations into STARS. As a result, other OCIE staff members, including personnel in the regional offices, were unaware of OCIE's ongoing cause examination of BMIS. In fact, the 2005 NERO Cause Examination team learned of OCIE's examination directly from Madoff during May 2005 and contacted OCIE, which until then, was unaware of the ongoing NERO examination of BMIS. The failure of one office to realize a duplicative examination was being conducted by another office resulted in embarrassment and a waste of Commission resources.

Once the two teams became aware of their common objective, the exchange of documents and information was inadequate. The 2004 OCIE Cause Examination team sent their examination papers to NERO on June 9, 2005. The 2005 NERO Cause Examination team noted that OCIE never documented their findings and did not provide a status report or closing memorandum that would identify any conclusions and open issues (See Finding 11). At the time, OCIE did not have formal policies and procedures that required closing memoranda for examinations.

Presumably, OCIE now has new procedures for the use of STARS. An OCIE document titled, "Office of Market Oversight's Document Policies and Procedures," dated November 27, 2007, indicates that only non-SRO⁷ examinations (broker-dealers, investment advisers, investment companies and transfer agents) should be entered into STARS. However, on June 5, 2009, OCIE indicated to the OIG that it intends to ensure that SRO inspections will be included as well.

As to documentation of findings, OCIE's Examination Program Manual for Organization of Examination Workpapers dated July 8, 2008 now provides guidance with regard to a number of issues confronted by the examiners. For instance, the manual indicates that examiners should prepare and retain summaries of significant discussions with the registrant's personnel or outside parties and the examiner should note any significant unresolved issues in the workpapers. The Program Manual states that a list of these unresolved issues

⁷ SRO stands for Self-Regulatory Organizations, such as FINRA and U.S. securities exchanges.

should be prepared and given to the branch chief or team leader for review and disposition prior to closing the examination/inspection, that all discussions regarding document production should be documented (including use of a call log), and that the examiners should retain notes or emails as to why any documents were inexplicably or extraordinarily delayed or could not be produced.

Documenting interviews of registrants and third-parties during examination activities is critical to the conduct of an effective examination. In addition, mandating and enforcing vigilant use of an examination tracking system (currently the STARS system) is necessary to ensure that SEC examination are conducted efficiently and appropriately and information is properly shared between offices.

Recommendation 14:

Substantive interviews conducted by the Office of Compliance Inspections and Examinations (“OCIE”) of registrants and third-parties during OCIE’s pre-examination activities and during the course of an active examination should be documented with notes circulated to all team members. After each substantive interview during the examination, the team leader should re-evaluate the examination scope and methodology as set out in the Planning Memorandum to determine if the examination needs to be expanded and indicate by initialing the interview notes that the team leader has performed that evaluation.

Recommendation 15:

The workpapers for a given examination should be in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues.⁸

Recommendation 16:

When logging all Office of Compliance Inspections and Examinations examinations into an examination tracking system, the team leader should verify that the appropriate entry is made into the tracking system and, with a notation in the Planning Memorandum, indicate that such entry has been made with the team leader’s initials.

⁸ This requirement for work paper documentation is taken from the objectives of audit work paper documentation for public company audits adopted by the Public Company Accounting Oversight Board as expressed on paragraph 4 of Auditing Standard 3:

Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues. [Footnote omitted.]

Recommendation 17:

The Office of Compliance Inspections and Examinations should annually review and test the effectiveness of its policies and procedures with regard to conducting, documenting and concluding its examinations⁹ and modify the policies and procedures, where needed.

Finding 7: OCIE and NERO Did Not Form Appropriate Examination Teams Necessary to Conduct the Examinations

OCIE's SRO group and NERO did not form appropriate examination teams necessary to conduct their cause examinations of BMIS based on the allegations raised in the Hedge Fund Manager's Complaint and 2004 Complaint, which included issues typically examined by investment adviser personnel including verification of purported investment returns and account balances. Although the SRO group and NERO had no significant experience conducting examinations related to verification of purported investment returns and account balances, the examination teams did not include individuals with such expertise.

OCIE management acknowledged that its investment adviser personnel would have known to look specifically at the investment returns and verify custody of the assets, yet such personnel were not contacted for such assistance in connection with both the 2004 OCIE Cause Examination and 2005 NERO Cause Examination of BMIS.

An appropriately thorough analysis of the Hedge Fund Manager's Complaint and 2004 Complaint leading to the creation of the examination teams should have indicated to the individuals selecting the team that a collaboration between the BD and IA groups was necessary to fully understand certain issues raised, including, but not limited to, the BMIS fee structure, unusually consistent returns, purported trading strategy and accounts going to cash each month. Collaboration among the groups from BD and IA was critical in order to utilize IA's expertise associated with fee structures, compensation

⁹ Similarly, investment firms are required to develop and implement policies and procedures designed to guide their securities activities and detect and prevent violative conduct. Broker Dealer policies and procedures must be reviewed for adequacy on an annual basis – see FINRA Rule 3130(b). Investment advisers must conduct an annual review of their policies and procedures – see Investment Advisers Act of 1940 Rule 206(4)-7(b).

arrangements, performance reporting, performance marketing materials, custodial arrangements and cherry-picking.

Both examination teams lacked a Branch Chief during the examinations. A Branch Chief that was initially assigned to the 2004 OCIE Cause Examination was promoted to Assistant Director and was never replaced with another Branch Chief. During the 2005 NERO Cause Examination, a Branch Chief was never assigned. As a result, examiners were left unsupervised for significant portions of the onsite examination. There was also no clear designation as to who served as team leaders during both examinations.

The examination teams also lacked expertise related to effectively identifying signs of fraud. The inconsistent and contradictory explanations of trading strategies that Madoff provided to both examination teams and Madoff's suspicious behavior, which included, agitation, secrecy and anger when certain documents or information was sought during the 2005 NERO Cause Examination, should have been interpreted as indications that he was deliberately misleading staff in order to mask illegal activity. Training in understanding behavioral communication such as agitation, secrecy and anger would appear to be a missing component of the OCIE examiner's repertoire.

In a letter dated July 1, 2009 to OIG, OCIE indicated that it has made significant enhancements to the examination process since the Madoff fraud was revealed in December 2008 including, but not limited to:

- Joint regulatory (SEC, Financial Industry Regulatory Authority ("FINRA") and North American Securities Administrators Association ("NASAA")) training for examiners on strategies to detect and investigate indications of fraud of various types, including Ponzi schemes, offering frauds, manipulations and other types of fraud.
- Special OCIE training conducted in March 2009 with regard to strategies to identify and investigate Ponzi schemes, affinity frauds and other related schemes.
- Training for more than 300 examination staff to become Certified Fraud Examiners.
- Focused training in particular key areas such as options, derivatives, trading, anti-money laundering, financial/net capital issues and issues associated with firms that are registered as both broker-dealers and investment advisers.
- Expanding examination activity of joint or dual registrants to assure that examiners have "eyes on" all activities, particularly advisers that use an affiliated broker-dealer for custody of advisory clients' assets.

The failure to form appropriate examination teams and the resulting inexperienced teams led to an inability to conduct the cause examinations of BMIS in an effective manner and must be remedied in order for OCIE to uncover fraud in future cause examinations.

Recommendation 18:

The focus of an examination should drive the selection of the examination team and team members should be selected based upon their expertise related to such focus. There should also be a clearly defined examination team leader. Staffing decisions should be made by senior Office of Compliance Inspections and Examinations management (assistant director level or higher) after management has performed adequate pre-examination preparation so that management can make appropriate choices. The examination team should not be selected solely based on availability.

Recommendation 19:

Senior Office of Compliance Inspections and Examinations (“OCIE”) management should ensure that personnel with the appropriate skills and expertise are assigned to cause examinations with unique or discrete needs (i.e., options expertise). OCIE should regularly seek out the appropriate expertise from other offices or divisions within the SEC and encourage intra-agency collaboration wherever possible.

Recommendation 20:

The Office of Compliance Inspections and Examinations should assign a Branch Chief, or a similarly designated lead manager, on every substantive project including all cause examinations. The Branch Chief or designated lead manager must be onsite or in direct communication with the onsite staff daily during the onsite portion of the examinations. Lower lever or junior staff examiners must not be left unsupervised during substantive discussions with principals or senior executives at the registrant during the examination.

Recommendation 21:

The Office of Compliance Inspections and Examinations (“OCIE”) should develop a formal plan with specific goals associated with achieving and maintaining professional designations and/or licenses by industry certification programs that are relevant to the examination activities conducted by OCIE. For instance, within the next three years, 50% of OCIE staff and management associated with examination activities should be qualified by means of a certification applicable to their profession such as the Association of Certified Fraud Examiners’ Certified Fraud Examiner designation, the American Institute of Certified Public

Accountants' Certified in Financial Forensics designation and/or the FINRA General Securities Principal license required of investment professionals.¹⁰ These should include an annual continuing education component for each of these licenses.

Recommendation 22:

The Office of Compliance Inspections and Examinations ("OCIE") should develop and implement interactive exercises to be administered by OCIE training staff or an independent third party and reviewed prior to hiring new OCIE employees in order to evaluate the relevant skills necessary to perform examinations. Similar exercises should be annually administered to all active examination staff and management in order to identify areas that need further development.

Finding 8: The Examiners Did Not Contact Madoff's Clients to Determine Whether He Provided Investment Advice

The Examiners did not contact Madoff's clients to corroborate his statement that he did not render investment advice. Although names and addresses of Madoff's clients were obtained by examination staff, the examiners never contacted any of the clients during their cause examinations.

During the course of the 2004 OCIE and 2005 NERO Cause Examinations, both examination teams considered whether or not BMIS should be registered as an investment adviser. One consideration, in particular, was whether or not BMIS exercised discretionary authority over the accounts or whether the firm acted strictly as an executing broker as Madoff often claimed. The written Trading Authorization Directives provided by BMIS indicated that Madoff had discretion over trading in the accounts of customers for which he implemented the split-strike conversion strategy. One approach to verify whether BMIS was exercising discretion and thus serving as an investment adviser would be to contact the firm's clients and ask who authorizes trades.

¹⁰ The investment firms that OCIE examines are required to have their professionals qualified by exam to perform securities investment activities. OCIE professionals should have a similar requirement in order to review and examine those activities. The FINRA General Securities license consists of the Series 7 and 24 courses covering the sales of securities and the supervision of such sales. The study materials are readily available from several providers. While OCIE examiners may not be able to sit for certain exams and obtain certain licenses due to their status as government employees, they are still able to obtain and study the course materials.

During the 2004 OCIE Cause Examination, examiners obtained a list of clients for which Madoff utilized the split-strike conversion strategy. However, the OCIE team did not contact the institutional clients Madoff identified, possibly due to concerns about disrupting BMIS' business. During the 2005 NERO Cause Examination, examiners also obtained a list of clients for which BMIS utilized the split-strike conversion strategy, but the examination team did not contact any of the funds on the list.

Had the examination team contacted BMIS' clients, those funds could have confirmed that BMIS had full discretion over their accounts as well as the implementation of the trading strategy for those accounts. The funds could have also provided additional detail with regard to the trading, clearing and settlement process and who was involved in that process. Finally, each fund contacted could have verified the number of accounts they had with BMIS in order to confirm whether Madoff was accurately reporting the number of accounts for each fund to examination staff. A number of BMIS' clients were SEC-registered investment advisers, which meant that the SEC had authority to request additional information under Section 204 of the Advisers Act.

We understand that OCIE has procedures in place with regard to contacting registered and unregistered entities for information. SEC Form 1661 "Supplemental Information for Regulated Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena" is supposed to accompany a document request sent by OCIE and provide the registrant information concerning the possible uses of such information. SEC Form 1662, "Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena" is also supposed to be used when contacting a person or entity that is not registered with the SEC, such as a registrant's client or customer.

Contacting clients to corroborate statements made by the registrant's representative may be critical to uncovering fraud in a cause examination.

Recommendation 23:

Subject to approval of the examination team leader, Office of Compliance Inspections and Examinations ("OCIE") examiners should contact clients of a BD or IA when necessary to confirm statements made by BD or IA personnel. Examiners should be encouraged to verify representations of third parties by contacting such parties, and appropriate methods used to contact third parties should become a part of OCIE's training of examiners.

Finding 9: The NERO Examiners Did Not Follow-Up on Numerous Contradictions Discovered During the 2005 NERO Cause Examination

The 2005 NERO Cause Examination team did not recognize that Madoff was either lying to the examiners and/or the feeder funds were making misrepresentations to their clients with regard to how the split-strike conversion strategy was being implemented. Madoff indicated to the examination staff that he no longer traded options for the strategy, which contradicted press reports and information contained in the 2004 Complaint with regard to implementation of the strategy. A number of other issues were never fully resolved including the number of clients, custody of the assets and verification of bank account numbers of various accounts

Though the 2005 NERO Cause Examination was focused on front-running and cherry-picking, one examination team member picked up on the options trading volume issue raised in the 2004 Complaint. The examiner's handwritten notes in the workpapers indicate that he recognized that there were questions as to "who is writing these OTC contracts." The options issues were never examined however, apparently because the examiner was told by Madoff that he no longer utilized options trading in the split-strike conversion strategy after January 2004. The examination team was or should have been aware that this information was inconsistent with the MAR/Hedge and Barron's articles as well as information contained in the 2004 Complaint. Assuming that Madoff was telling the truth about his options activity, the examination team did not follow up with BMIS' feeder funds as to whether those feeder funds may have intentionally or unwittingly misrepresented to their investors how the strategy was being implemented, or whether the strategy could be implemented without the use of options. Such misrepresentations to clients may violate securities laws.

In a memorandum examiners wrote summarizing a meeting with Madoff, they described how Madoff had changed his story several times. For example, Madoff had said he had no advisory clients, then he had claimed to have four, and then "closer to 15." At one point during the examination, an examiner didn't believe the account numbers provided by Madoff were accurate and indicated that he would research record requirements for those accounts.

To the extent possible, all discrepancies should be resolved, no matter how small, as they frequently are indicators of a more serious problem. The preferable method to resolve a discrepancy is to contact the outside parties involved.

Examination findings that lead to issues at other securities and investment firms must be followed up in order for thorough examinations to be conducted and fraud to be uncovered.

Recommendation 24:

In the course of an examination, if an examiner becomes aware of a potential securities law violation at another firm, that examiner should consult with the team leader and the Office of Compliance Inspections and Examinations should make a referral to the appropriate personnel or agency.

Finding 10: The Examiners Did Not Understand How BMIS Executed, Cleared and Settled Trades

Numerous questions were raised by both examination teams regarding BMIS' trading. The OCIE staff could not understand why BMIS' trade dates and settlement dates were inexplicably inconsistent and varied when compared to the securities industry standard of T+3 (trade date plus three days) and why certain option trades preceded the equity transactions when the examiner's understanding of the split-strike conversion strategy would have indicated otherwise.

The 2005 NERO Cause Examination staff also had questions about Madoff's trading and settlement activity regarding the discretionary brokerage accounts for his investment advisory clients. The examination staff had been told by Madoff that Barclays Bank PLC "clears for the brokers in London," and, in early May 2005, a NERO document request was sent to Barclays asking for "[a]ll trading done by or on behalf of . . . Fairfield Sentry Ltd.," "Kingate," and "[a]ny account over which Bernard Madoff (or any entity known to the firm to be affiliated with Bernard Madoff or Madoff Securities) has any direct or indirect trading authority." In mid-May, Barclays responded to NERO's information request, stating that BMIS had recently opened an account at Barclays, but there was no recent transaction activity in the account. The response also stated, "[i]t should be noted that a prime brokerage and trading relationship with a Madoff-affiliated entity exists with our UK affiliate, Barclays Capital Securities Ltd., an FSA-regulated institution." NERO, however, never contacted Barclays Capital

Securities Ltd. and, therefore, never verified Madoff's purported European trading activity regarding the discretionary brokerage accounts for his investment advisory clients.

During late May 2005, a NERO supervisor instructed the 2005 NERO Cause Examination team to confirm the details of how BMIS executed and cleared trades. The NERO examiners identified a number of unresolved issues regarding the potential role of a number of entities including the executing broker, prime broker, London Stock Exchange, Barclays and the BMIS U.K. affiliate. One NERO examiner indicated that these issues were discussed with Madoff and although Madoff was "somewhat vague regarding the actual execution and clearance of trades," the examiners relied upon Madoff's verbal representations. The NERO manager that supervised the examiners did not recall whether the examination team ever followed up on the details of BMIS' trade executions.

OCIE now has general "Guidance for Contacting Foreign-Based Entities and Individuals" provided by the SEC's Office of International Affairs. OCIE has recently developed templates for contacting registered and unregistered custodians to assist in the verification of assets during examinations of broker-dealers and investment advisers.

The failures by the OCIE examination teams to understand critical representations made by Madoff about his trading activity as well as the failures to appreciate information obtained during the course of the examinations concerning Madoff's lack of trading contributed to OCIE's inability to uncover Madoff's Ponzi scheme. Training is necessary to ensure that OCIE examiners understand the issues they are examining.

Recommendation 25:

The Office of Compliance Inspections and Examinations examiners should be trained in the mechanics of securities settlement, both in the U.S. and in major foreign markets.

Recommendation 26:

The Office of Compliance Inspections and Examinations ("OCIE") examiners should be trained by the Office of International Affairs ("OIA") in methods to access the expertise of foreign regulators, such as the United Kingdom's Financial Services Authority, as well as foreign securities exchanges and foreign clearing and settlement entities. OCIE examiners should also be trained by OIA in methods to request and receive information pursuant to SEC Memoranda of Understanding with those foreign regulators. OCIE in conjunction with OIA should develop templates for the most frequent types of requests (i.e., sample

trade data) from foreign regulators based on past experience in order to facilitate the process. OCIE in conjunction with OIA should develop and utilize contact lists with such regulators for use by appropriate examination staff.

Recommendation 27:

For significant issues such as whether trades have been executed and who has custody of assets, in the absence of third party (counterparties, custodians, etc.) documentation, the Office of Compliance Inspections and Examinations (“OCIE”) examiners should not simply rely on representations of BD or IA personnel but should contact third parties directly. OCIE should provide guidance or training that clarifies for examiners circumstances that require such contact with third parties.

Finding 11: Neither the OCIE Nor the NERO Examination Team Attempted to Acquire Trading Data from FINRA/NASD, DTC/NSCC or Other Independent Third Parties in Order to Verify the Trading Volume Purported by Madoff on Feeder Funds’ Account Statements

The OCIE staff prepared a draft letter to the NASD, dated December 17, 2003 in connection with the 2004 OCIE Cause Examination of Madoff, but the staff never sent the letter. Nor did the OCIE staff ever request trading data (e.g., audit trail data) from another independent third party. The 2005 NERO Cause Examination team did not make any attempt to reach out to an independent source for trading data in the course of their examination. Had the 2004 OCIE or the 2005 NERO Cause Examination teams approached independent third parties, they would have obtained detailed transaction data as well as securities position data for BMIS on a daily basis.

The National Association of Securities Dealers (“NASD”, now “FINRA”) was, and still is, the largest independent regulator for all securities firms doing business in the United States, including its former subsidiary, the National Association of Securities Dealers Automated Quotations (“NASDAQ”) Stock Market,¹¹ during the period of 2004 through 2006. Through NASDAQ, FINRA/NASD collects

¹¹ The NASDAQ Stock Market became an independent entity in January 2001 and registered as an exchange in August 2006.

detailed trading data from all market participants who are members of the NASD, including BMIS, on a daily basis.¹²

Additionally, National Securities Clearing Corporation (“NSCC”), a subsidiary of the Depository Trust and Clearing Corporation (“DTCC”), provides clearing, settlement and central counterparty services for virtually all broker-to-broker trades involving equities, corporate and municipal debt and exchange-traded funds, etc. As a result, NSCC also provides a cleared and settled trade database on a daily basis. On the other hand, Depository Trust Corporation (“DTC”), another subsidiary of DTCC, maintains records that show, on any particular day, a market participant’s securities positions (equity, exchange-traded funds, corporate debt and municipal debt, etc.).¹³

Finally, the Options Clearing Corporation (“OCC”) collects trading data for all cleared and settled option trades, including S&P 100 Stock Index (“OEX”) options, by its member firms, such as BMIS.

During the planning stage of the examination, the 2004 OCIE Cause Examination team had drafted a letter intended to request trading data related to BMIS directly from FINRA/NASD, but the letter was never sent. The NERO examination team did not make any effort to reach out to an independent source for trading data at all. During both examinations, it does not appear that the NASD or any other independent source, such as DTCC, was ever contacted in order to validate the transactions provided by BMIS. The FTI Engagement Team believes had either examination team approached FINRA/NASD, DTC/NSCC or OCC, detailed transaction data as well as securities overnight position data could have been obtained to challenge BMIS’ purported trading volume for both equities and options.

¹² Specifically, the NASDAQ Automated Confirmation of Transactions (“ACT”) database. Additionally, FINRA/NASD also established an Alternative Display Facility (“ADF”) for member firms who choose to report to ADF instead of ACT.

¹³ DTC provides securities movements for NSCC's net settlements, as well as settlement for institutional trades, which typically involve money and securities transfers between custodian banks and broker-dealers.

Finding 12: Had the OCIE or the NERO Examination Team Conducted a Trading Volume Analysis Based on Third Parties' Data, They Would Have Uncovered a Significant Red Flag That, With Further Inquiry, Would Likely Have Led to Discovery of the Ponzi Scheme or, At the Very Least, Madoff's Fictitious Trades

As a result of not requesting and obtaining data from third parties, validation of equity and options trading volume was never undertaken by either examination team during the 2004 OCIE Cause Examination or the 2005 NERO Cause Examination. Had the staff requested audit trail data and/or clearing and settlement information from third parties, it is likely that the examiners would have discovered that Madoff was not making the trades he claimed to be making.

OIG's Report of Investigation dated August 31, 2009 demonstrates that at no time did the two teams of the SEC examiners (2004 OCIE and 2005 NERO Cause Examination teams) initiate a comprehensive analysis to verify the trading volume of equity securities and OEX options as asserted by Madoff and reflected in the feeder funds' statements, despite receiving several tips and complaints that raised suspicion about BMIS' trading strategy and returns. The FTI Engagement Team believes that had either examination team conducted a detailed review of trading volume based on feeder fund account statements produced by BMIS compared to third-parties' transaction data as well securities overnight position data, significant red flags would have been raised that should have prompted further inquiry, and the follow-up inquiry would likely have led to the discovery of the Ponzi scheme, or at the very least, Madoff's fictitious trading.

Summary of Received Tips in Regard to Trading Volume Issues

2004 OCIE Cause Examination. In late 2003, when OCIE was assembling a team and preparing to conduct a cause exam of BMIS, the team possessed the following information in regard to anomalies of professed trading activities undertaken by BMIS:

- The Hedge Fund Manager's Complaint received from a hedge fund manager indicated that the presumed OEX options volume done by Madoff could not be verified by the actual volume reported on the Chicago Board Options Exchange ("CBOE") where, according to Madoff, those options should have traded;
- A May 2001 MAR/Hedge article entitled "Madoff tops charts: Skeptics ask How" described Madoff's "related ability to buy and sell the underlying stocks without noticeably affecting the market," even though his trading volume of those stocks should have been in the billions of dollars on a daily basis; and
- A Barron's article entitled "Don't Ask, Don't Tell: Bernie Madoff is so secretive, he even asks his investors to keep mum," published on May 5, 2001, raised many of the same issues as in the MAR/Hedge article.

As the OIG Report of Investigation describes, the 2004 OCIE Cause Examination team never requested trading and position data from a third-party source. Consequently, the OCIE team did not examine the market impact of Madoff's alleged options trading, as specified in the Hedge Fund Manager's Complaint from the investment adviser, and did not verify or reconcile the related equity trading volume. The examination team also did not take any measure to verify whether or not Madoff was trading options on CBOE or on other options trading venues including over the counter ("OTC") market.

2005 NERO Cause Examination. In 2004, NERO possessed the following information in regard to alleged abnormal trading activities undertaken by BMIS:

- The 2004 Complaint raised suspicion about Madoff's equity trading stating the firm had "totally independent evidence that Madoff's executions were highly unusual."¹⁴
- The 2004 Complaint raised suspicion about Madoff's options trading strategy and concluded that Madoff could not be trading on an exchange because of insufficient volume and could not be trading options over the counter because it was inconceivable he could find sufficient counterparties for the quantity of trading necessary to implement the split-strike conversion strategy.
- The Mar/Hedge article and the Barron's article from May 2001 were also available for the 2005 NERO Cause Examination team at the start of the examination process.

As the OIG's Report of Investigation shows, the 2005 NERO Cause Examination team did not attempt to substantiate Madoff's equity trading volume or the

¹⁴ The firm that provided the 2004 Complaint had done an analysis of Madoff's fills, or trade execution prices. The firm's employees who analyzed the fills concluded that it was highly unlikely that Madoff's executions could be legitimate.

options trading volume. In fact, Madoff's options trading was not a focus of the examination at all after Madoff told the team that he was no longer using options as part of his strategy. There is no evidence that the NERO team ever considered contacting the NASD or the DTCC for third-party trading data.

Trading Data and Markets

The FTI Engagement Team replicated the 2004 OCIE Cause Examination data request to NASD (now FINRA) as if OCIE's draft letter, which was never sent, had in fact gone to NASD; however, we limited the time period of the request to March 10 – 15, 2005 and the range of the request to selected securities to coincide with dates and securities shown on account statements provided to BMIS feeder funds found in OCIE workpapers. Furthermore, the FTI Engagement Team also obtained trading data from NSCC for the same time period of 2005 and securities position data from the Depository Trust Corporation ("DTC").

The FTI Engagement Team compared BMIS' reported equity trading volumes from a sample of feeder fund account statements to BMIS' trade reporting records submitted to the NASD, as well as BMIS' trade clearing and settlement records provided by the NSCC.¹⁵ In addition, the FTI Engagement team compared BMIS' securities position data provided by DTC for January 2005 to overnight securities holdings shown in BMIS account statements for its feeder fund client.

The FTI Engagement Team's analysis showed the following:¹⁶

- An analysis performed using data from the NASD/FINRA, NSCC and/or DTC would have likely resulted in uncovering during the examinations that Madoff was misrepresenting his trading.
- The FTI Engagement Team's analysis shows that, for one feeder fund manager alone, Kingate Management, Ltd. ("Kingate"), purported trading volume in U.S. markets for selected securities shown on BMIS statements significantly exceeded actual trading volume by BMIS in those securities, according to NASDAQ Automated Confirmation of Transactions ("ACT") data provided by FINRA. In fact, the feeder fund's volume surpassed the ACT volume for every single stock on every single trading day which the

¹⁵ The FTI Engagement Team selected a sample of 14 stocks out of the total 44 stocks professed to be traded by Madoff for Kingate from March 10 through March 15, 2005.

¹⁶ Appendix VI provides a more an in depth description of the FTI Engagement Team's trading volume analysis, including databases, procedures, methodologies as well as a detailed breakdown of total volume calculated for each stock on each trading day during March 2005 which is based on the records in Kingate and Fairfield's account statements, NASDAQ ACT, FINRA OATS, NSCC and DTC databases.

FTI Engagement Team has investigated by a factor ranging from two to as much as 12.¹⁷ Moreover, Madoff eventually claimed to have executed trades for “closer to 15” feeder funds; therefore, the discrepancies of volume would have been even more significant had other feeder funds’ purported volume been factored into this analysis. The FTI Engagement Team concluded that had the examiners done a similar analysis, the disparity in US trading volume would have been uncovered during their examinations.

- The FTI Engagement Team also compared the same trading volume as recorded in the feeders fund’s account statements to the volume cleared and settled by NSCC on behalf of Madoff during the same period. Similar to the results using the data from FINRA, purported trading volume for the feeder fund significantly exceeded actual trading volume by BMIS in those securities, as cleared by NSCC. Likewise, had the FTI Engagement Team included other feeder funds’ purported trading volume, as well as deducted BMIS’ actual market making volume from the NSCC cleared volume, the divergence of volume would be even more obvious and substantial.¹⁸
- Finally, the FTI Engagement Team also compared BMIS’ securities position holdings as reported by DTC to the overnight equity position of one of the feeder funds, Fairfield Sentry, Ltd. (“Fairfield”), based on a sample of trade confirmations issued by BMIS to the feeder fund. Based on the FTI Engagement Team’s research, BMIS did not hold billions of dollars of S&P 100 equities for Fairfield, as listed on the account statements. For example, on January 26, 2005, DTC records showed that the BMIS account held a total of 90,200 shares of 14 S&P 100 equities in the DTC account.¹⁹ However, the trade confirmation statements produced by BMIS for the feeder fund show total holdings of 35,682,300 shares for those same 14 stocks as of January 26, 2005, which exceeded the shares recorded in DTC by a factor of almost 400.

¹⁷ For example, on March 14, 2005, Kingate’s two fund statements show a total buy and sell trading volume of 1,643,600 shares for Oracle Corporation (“ORCL”), while the reported volume submitted to ACT by BMIS was only about 136,850 shares. For that date, then, Kingate’s recorded volume was 12 times as large as the NASDAQ reported volume.

¹⁸ Data relating to trades reported by BMIS to NASDAQ ACT or NSCC would be available only to the SEC, FINRA, NASDAQ and DTCC. Absent any specific legal authority, neither the BMIS feeder funds, nor their advisors and auditors, would have had access to the trade execution data needed to prepare an analysis similar to that which the FTI Engagement Team performed for this report.

¹⁹ Most of the shares held by BMIS at DTC were likely related to BMIS market-making positions only. The FTI Engagement Team concluded that the DTC records would have included additional shares held by Madoff for its investors had Madoff conducted genuine trades in U.S. markets for those investors because Madoff was acting as their custodian.

- Even if Madoff represented to NERO examiners that BMIS executed trades for institutional clients in Europe before the U.S. markets were open, the examiners should have been prompted to pursue additional information on Madoff's claimed European trade executions because, on its face, such a representation raised serious red flags. The after-hours markets for US stocks traded in both U.S. and Europe were viewed as illiquid.²⁰ It was not likely that BMIS would transact several hundred thousand shares of volume for each individual stock on each day, as it purported to do for its investment adviser accounts, between 4:00 am and 8:00 am on a European exchange when the market for this time period is viewed by the industry as illiquid. With the knowledge that the European market for U.S. equities was so limited, the examiners would have had a solid indicator to pursue information from European regulators, and, in turn, investigate other issues such as custody and existence of client securities. Had the examination team possessed a basic understanding of the interactions between the U.S. and European markets, they likely would have reached this conclusion.

U.S. Treasury Holdings. In addition to equity positions, Fairfield's trade confirmations also purported to carry large U.S. Treasury debt positions overnight. In fact, on some days, Fairfield's entire portfolio was supposed to have been invested in US Treasury bills. US Treasury bills, though, could be held in both US and foreign depository institutions, making it difficult to obtain a definitive total of all holdings for a given broker-dealer such as BMIS. While OCIE examiners could have made inquiries of US and foreign depository institutions, the examiners may have been dependent upon the cooperation of entities not under SEC supervision, lowering the likelihood of successfully reaching a conclusion.

Options Trading. The FTI Engagement Team was not able to verify options trading volumes due to incomplete data. In fact, the 2005 account statements produced by BMIS to two of its feeder fund clients did not show any trading in S&P 100 stock index ("OEX") options or other options.²¹ The FTI Engagement Team has verified that BMIS was a member of the Options Clearing Corporation ("OCC")²² and also a member of Pacific Stock Exchange, which is known for its electronic options trading platform, during the period from 2004 – 2005.²³ Therefore, the SEC examination teams could have requested options trading data directly from OCC or the options exchanges in regard to BMIS' purported

²⁰ See "After-Hours Trading: Understanding the Risks"
<http://www.sec.gov/investor/pubs/afterhours.htm>.

²¹ However, we do have Fairfield trade confirmations that showed trading of OEX options in 2005.

²² Members of OCC would have to have reported all exchange-listed option trades (including OEX trades) to OCC for clearing and settlement purposes.

²³ See BMIS FOCUS Reports for 2004 and 2005, Schedule I, filed with FINRA.

trading activities in OEX options.²⁴ As a result, it is likely that the OEX options' trading volume fabricated by Madoff could have been exposed once an analysis of options' trading volume was accomplished.

As the above demonstrates, the FTI Engagement Team has concluded that there were several methods for the SEC examiners to verify BMIS purported trading volume with several different independent third-parties. Reaching out to any of these third-parties would have revealed discrepancies between Madoff's representations concerning his trading volume and reality. Had the SEC examiners undertaken any of the volume or position analyses discussed above, they would have uncovered a significant red flag that, with further inquiry, would likely have led to discovery of the Ponzi scheme or, at the very least, Madoff's fictitious trading volume.²⁵

Recommendation 28:

The Office of Compliance Inspections and Examinations examination staff should be required to verify a test sample of trading or balance data with counterparties and other independent third parties such as Financial Industry Regulatory Authority, Depository Trust Company, or National Securities Clearing Corporation whenever there are specific allegations of fraud involved in an examination.

Recommendation 29:

The Office of Compliance Inspections and Examinations ("OCIE") examiners should be trained jointly with the Office of Economic Analysis economists by FINRA, other self-regulatory organizations and exchange staff in understanding the trading databases provided by the Financial Industry Regulatory Authority, The NASDAQ OMX Group, Inc., the New York Stock Exchange/Archipelago Holdings, Inc./American Stock Exchange, regional exchanges, Options Clearing

²⁴ A listed option such as OEX options could not have been traded solely over-the-counter and not reported to any regulated entities such as OCC or option exchanges. A broker-dealer could only trade a non-listed option over-the-counter. However, it is possible that a non-listed option that mimics OEX options with similar characteristics (e.g., a similar stock mix with volatility proximity) could be traded exclusively over-the-counter, although this scenario would be inconsistent with Madoff's previous statements that he was trading OEX options only.

²⁵ To minimize the resources required by OCIE to analyze trade data provided by FINRA (NASDAQ ACT and OATS databases), the FTI Engagement Team suggests that FINRA invest time and technical personnel to build the following two new databases based on the existing raw data: 1) a new database that would combine all OATS tables (order entry, routing, execution, cancellation, modification, etc.) into one "super" table so that examiners could easily understand the life cycle of a customer order submitted to a market participant; and 2) a "cleaned-up" version of a "super" ACT trade database that would eliminate the redundancies of tape-reported records and clearing records. FINRA should make the new databases available for request by the SEC (especially OCIE and OEA). Because this suggestion is directed at FINRA, not the SEC, the FTI Engagement Team is not including it as a formal recommendation, but wishes to bring it to the SEC's attention.

Corporation, option exchanges, and Depository Trust Clearing Corporation/National Securities Clearing Corporation, etc. As trading and trading venues change over time, the OCIE training should be recurring and updated.

Recommendation 30:

The Office of Compliance Inspections and Examinations staff should be given direct access to certain databases maintained by self-regulatory organizations or other similar agencies in order to allow examiners to access necessary data for verification or analysis of registrant data. Such databases should include exchange trading execution data, Depository Trust Company / National Securities Clearing Corporation data, the Financial Industry Regulatory Authority (“FINRA”) Order Audit Trail System and the FINRA Central Registration Depository.

Finding 13: OCIE Did Not Adequately Track the Progress of its Cause Examination of BMIS

OCIE did not adequately track the progress of its 2004 OCIE Cause Examination of BMIS. OCIE team members were pulled from the project and never returned to work on the cause examination even though it was never completed.

The 2004 OCIE Cause Examination never reached a formal conclusion as the examination team was diverted to address another priority. The OCIE examiners were told by their supervisors to focus on a mutual fund revenue sharing sweep being conducted by OCIE. The examination team did not draft a closing report of the BMIS cause examination, and when the mutual fund revenue-sharing project was completed, the 2004 OCIE Cause Examination of Madoff did not resume.

A senior OCIE manager indicated that one particular individual was responsible for keeping track of open examinations. However, this individual testified that although she maintained a spreadsheet that listed ongoing projects, she did not have the responsibility for monitoring whether examinations were completed and that the responsibility for ensuring that an examination was completed fell to the branch chief, the assistant director and the associate director in charge of the project.

According to the letters dated June 5, 2009 and July 1, 2009 from OCIE to OIG, in late 2003 and 2004, Market Oversight was particularly busy with a number of high-profile sweep examinations that required significant staffing

resources. As a result, other projects, including the 2004 OCIE Cause Examination of BMIS, suffered considerable delays.

As a result of the failure by OCIE to reach a formal conclusion and adequately trace the progress of the cause examination, the examination work conducted by the 2004 OCIE Cause Examination team was rendered useless.

Recommendation 31:

When an examination team is pulled off the examination for a project of higher priority, upon completion of that project, the examination team should return to their examination and bring the examination to a conclusion.

Recommendation 32:

One person in The Office of Compliance Inspections and Examinations (“OCIE”) should be responsible for tracking the progress of all cause examinations, and the tracking should include the number of cause examinations opened, the number on-going and the number closed for each month. Such data should be reported at least quarterly to the OCIE Director and to the Securities and Exchange Commission (“SEC”) Chairman. Any cause examinations open for more than 180 days should be reported to the OCIE Director and the SEC Chairman with an explanation as to why the examination requires more time.

Finding 14: OCIE Did Not Prepare a Closing Report That Resolved the Allegations from the Hedge Fund Manager’s Complaint and Identified Any Substantive Open Issues Discovered During the Examination

The 2004 OCIE Cause Examination team did not prepare a closing report that resolved the allegations from the Hedge Fund Manager’s Complaint and identified any substantive open issues discovered during the examination.

Had the 2004 OCIE Cause Examination been brought to a conclusion, presumably the examination team would have determined there was no front-running, but other issues remained. Senior OCIE managers have

indicated that if they were doing the examination and did not find front-running, then they likely would have continued the examination, including a validation of investment performance and a review of the custody arrangements.

Although OCIE had begun drafting a memorandum to the Division of Market Regulation (now the Division of Trading & Markets) addressing whether or not BMIS should have been registered as an investment adviser, that memorandum was never finalized.

The failure to adequately address and resolve these issues can be linked to the overly narrow initial scope of the 2004 OCIE Cause Examination that focused on front-running. That scope was not modified to reflect the detailed Hedge Fund Manager's Complaint received by OCIE, even though members of the examination team talked with the individual that provided the tip shortly after the Planning Memorandum was drafted, nor was the scope adjusted to include the issue of investment adviser registration.

OCIE Office of Market Oversight's Document Policies and Procedures dated November 27, 2007 suggested that a closing memorandum "should" be completed for every project. However, a letter dated June 5, 2009 from OCIE to the OIG stated, "[o]nce an examination is completed, the [Market Oversight] Guidelines require that each examination or inspection have a final closing report or memorandum." Furthermore, OCIE's Examination Program Manual for Organization of Examination Workpapers dated July 8, 2008 suggested that final examination/inspection reports may, but not necessarily must, be retained in examination files. OCIE's Standard Report Format dated December 4, 2008 described the minimum content and format for examination reports, when prepared.

The above demonstrates the conflicting policies and procedures in effect. In addition, the failure to document conclusions from the 2004 OCIE Cause Examination demonstrates the importance of clarifying that closing reports must be prepared at the conclusion of each examination.

Recommendation 33:

The Office of Compliance Inspections and Examinations' policies and procedures should clearly indicate that at the conclusion of each examination, the examination team must prepare a closing report ("Closing Memorandum") that begins with the scope discussion from the Planning Memorandum, as modified by new issues that arise during the course of the examination. For each and every issue discussed in the scoping discussion in the Planning Memorandum, the Closing Memorandum should provide

findings relevant to each issue and state the team's conclusions. All members of the examination team should sign the Closing Memorandum.

Finding 15: The NERO Examination Team Closed the Examination Despite A Number of Open Issues

The 2005 NERO Cause Examination team closed the cause examination of BMIS despite a number of open issues including whether BMIS should have been registered as an investment adviser, the role of the BMIS London affiliate and how Madoff was able to generate the returns once NERO determined he was not front-running.

On June 2, 2005, a conclusion was reached by a NERO examiner that Madoff was not front-running his market-making customers in order to benefit his investment advisory clients. The examiner also noted that Madoff's "purchase & subsequent sale timing was excellent (buy low & sell high)." Although no analysis had been conducted, the examiner suspected that Madoff was "extremely well connected to European order flow information through his brokers (and possibly the investors in his fund) and is timing the market based upon that information rather than his retail order flow information." The examiners' supervisor later stated that "we never found [out] why he was making those returns" and also indicated that he could not rule out the possibility that Madoff was doing something else illegally to achieve those returns.

The 2005 NERO Cause Examination team spent several months reviewing documents and interviewing Madoff directly with regard to his split-strike conversion strategy but was still unable to understand how he was achieving his returns. Even though there were significant "red flags" outlined in both the 2004 Complaint that triggered the examination and the news articles, the 2005 NERO Cause Examination team never reached a resolution on the many issues concerning Madoff's returns.

OCIE's Examination Program Manual for Organization of Examination Workpapers dated July 8, 2008 indicates that workpapers should include a list of any unresolved issues that should be prepared and given to the branch chief or team leader for review and disposition prior to closing the examination/inspection.

Resolving issues provided in a complaint or uncovered during the course of a cause examination is critical to the conduct of a comprehensive examination.

Recommendation 34:

Examination staff should not leave open any substantive issue without providing a sufficient basis for such a determination or a plan to pursue that issue at an appropriate later time. In the event that issues are unresolved or cannot be pursued further, examination staff should formerly refer those issues to the appropriate Securities and Exchange Commission staff that may further investigate and resolve such issues.

Finding 16: The NERO Examination Team Believed They Might Be Subjected To Legal Liability If They Contacted The Feeder Funds

The 2004 NERO Cause Examination team believed they might be subjected to legal liability if they contacted the feeder funds. There was belief within the examination team that they might be sued if they contacted the feeder funds and those funds subsequently pulled their money out of BMIS.

In mid-June 2005, the Northeast Regional Office examiners indicated to their supervisor that they were interested in visiting Madoff's feeder funds in order to better gain an understanding of the strategy used by Madoff, to request marketing materials from the funds and to compare performance data of the funds. The supervisor told the examiners that they should not contact the funds, apparently due in part to his fear that they would be sued. One of the examiners believed that his supervisor was concerned about "potentially being liable if the hedge funds turned around and pulled their assets from Bernard Madoff."

Recommendation 35:

The Office of Compliance Inspections and Examinations ("OCIE") training should include instruction on personal liability, if any, assumed on the part of examiners for their actions in the course of performing their duties for OCIE.

Recommendation 36:

Office of Compliance Inspections and Examinations (“OCIE”) management should make clear that it will support OCIE examiners in their pursuit of evidence in the course of an examination, even if pursuing that evidence requires contacting customers or clients of the target of that examination.

Finding 17: The Examinations Did Not Adequately Look Into the Allegations of the Auditor’s Lack of Independence or Refer Such Allegations To the Appropriate Agency

Both the 2004 OCIE and the 2005 NERO Cause Examinations did not adequately look into the allegations of the auditor’s lack of independence or refer such allegations to the appropriate agency.

Despite concerns raised in the complaints, both the 2004 OCIE and the 2005 NERO Cause Examinations did not look into the allegations of the auditor’s lack of independence to determine if there was a conflict of interest. The lack of an independent auditor raises potential concerns with regard to safety of custody of assets. Without an independent auditor, there can be no assurance that the audits of BMIS were properly conducted. Such potential conflicts should heighten awareness of, and the need for, verification that BMIS had internal controls in place that are designed to effectively prevent certain inappropriate activities, such as misrepresentation of trading activity and the misappropriation of client assets. The examination teams could have confirmed whether the accountant verified, by actual examination, client funds and securities held by BMIS, since BMIS did not utilize an independent custodian. Based on the information provided in the Hedge Fund Manager’s Complaint and the 2004 Complaint, such inquiries should have been considered as an area for review during the cause examinations.

Lori Richards indicated in a June 17, 2009 speech at a SIFMA conference and in a letter dated July 1, 2009 to David Kotz that in the wake of Madoff and other frauds, OCIE is making changes to examination procedures. Among other things, these changes will include a more routine process with regard to contacting a firm’s independent auditor in order to understand the nature of its audit and determine whether the auditor confirmed or verified that assets held on behalf of customers actually exist.

Procedures must be put into place to ensure that serious questions about an auditor’s independence are investigated and examined.

Recommendation 37:

When an auditor's independence is questioned in a tip or complaint, the Office of Compliance Inspections and Examinations should report the information, if deemed credible, to the appropriate state board of accountancy and to the Public Company Accounting Oversight Board, if applicable, in addition to considering a referral to the Securities and Exchange Commission's Enforcement Division or other government agency.

Acronyms

ACT	Automated Confirmation of Transactions
ADF	Alternative Display Facility
Adviser Act	Investment Adviser Act of 1940
AMEX	American Stock Exchange
ARCA	Archipelago Holdings, Inc.
BD	Broker Dealer
BMIS	Bernard L. Madoff Investment Securities LLC
CBOE	Chicago Board Options Exchange
Company Act	Investment Company Act of 1940
CRD	Central Registration Depository
DTC	Depository Trust Company
DTCC	Depository Trust & Clearing Corporation
ECN	Electronic Communication Network
Enforcement	Division of Enforcement
Exchange Act	Securities Exchange Act of 1934
Fairfield	Fairfield Sentry
FINRA	Financial Industry Regulatory Authority (formerly NASD)
FSA	Financial Services Authority (United Kingdom)
FTI	FTI Consulting, Inc.
IA	Investment Adviser
IC	Investment Company
IA/IC	Investment Adviser/Investment Company
Kingate	Kingate Global Fund
LSE	London Stock Exchange
Madoff	Bernard L. Madoff
Market Regulation	Division of Market Regulation (now Trading & Markets)
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers (now FINRA)
NASDAQ	National Association of Securities Dealers Automated Quotations/ Nasdaq Stock Market
NERO	Northeast Regional Office (now NYRO)
NSCC	National Securities Clearing Corporation
NYRO	New York Regional Office (formerly NERO)
NYSE	New York Stock Exchange
OATS	Order Audit Trail System
OCC	Options Clearing Corporation
OCIE	Office of Compliance Inspections and Examinations
OEA	Office of Economic Analysis
OEX	S&P 100 Stock Index
OIA	Office of International Affairs
OIEA	Office of Investor Education and Advocacy
OIG	Office of Inspector General
OMI	Office of Market Intelligence
OMX	The NASDAQ OMX Group, Inc.
ORA	Office of Risk Assessment

OTC	Over the Counter
SEC/Commission	U.S. Securities and Exchange Commission
SIAC	Securities Information Automation Corporation
SRO	Self-Regulatory Organization
SRO/Market Oversight	Office of Market Oversight
STARS	Super Tracking and Reporting System
Trading & Markets	Division of Trading & Markets (formerly Market Regulation)

Scope and Methodology

Scope. The FTI Engagement Team's review of OCIE's examinations of BMIS included the following areas:

- OCIE's identification of red flags, improper conduct and illegal practices of BMIS and the ability of OCIE management to evaluate these issues and assign the appropriate SEC staff;
- OCIE's methodology, timeliness and effectiveness in initiating and performing "cause" examinations;
- OCIE's assessment of an entity's internal controls and compliance with regulations and securities laws;
- OCIE's procedures for documentation of its workpapers;
- OCIE's confirmation or verification of an entity's trading activity and customer account balances;
- OCIE's supervisory oversight of the examination staff;
- OCIE's coordination between the examination staff and other personnel in the various offices of SEC/OCIE;
- Adequacy of staffing and resources at OCIE to support effective and efficient examinations; and
- Other relevant aspects of the OCIE examinations of BMIS.

Methodology. This review was not conducted in accordance with the government auditing standards. The FTI Engagement Team's fieldwork in connection with this review began on July 6, 2009 during the in-person entrance interview of Lori Richards and John Walsh in Washington, D.C. The FTI Engagement Team reviewed the OIG's August 31, 2009 Report of Investigation, including related findings, exhibits, witness testimony and other supporting documentation (i.e., OCIE examination staff workpapers), and the FTI Engagement Team also interviewed over a dozen key personnel representing OCIE's broker-dealer, investment adviser and risk assessment programs. In addition, the FTI Engagement Team reviewed OCIE's policies and procedures with regard to its examination processes and other third-party records including Financial Industry Regulatory Authority ("FINRA") order and execution data, Depository Trust Corporation ("DTC") records and National Securities Clearing Corporation ("NSCC") records. The FTI Engagement Team also was granted access to OCIE's various intranet sites, including the Broker-Dealer, Investment Advisor/Investment Company, Office of Market Oversight, and Training Branch sites, in order to view its examination policies and procedures. The FTI Engagement Team performed its findings and recommendations review from June 25, 2009 through August 28, 2009.

List of Recommendations

Recommendation 1:

The Office of Compliance Inspections and Examinations (“OCIE”) should provide all examiners access to relevant industry publications (i.e., MAR/Hedge-type publications) and third-party database subscriptions sufficient to develop examination leads and stay current with industry trends. OCIE should regularly (i.e., quarterly) assess whether they have adequate access to relevant industry publications and other such sources (newsletters, independent subscription-type news alerts, etc.) and make reasonable attempts to gain such access.

Recommendation 2:

The Office of Compliance Inspections and Examinations should establish a protocol for searching and screening news articles and information from relevant industry sources that may indicate securities law violations at broker-dealers and investment-advisers. The protocol should include flexible searching capability to help identify specific areas of risk or concern and should include access to all relevant industry publications. The protocol should also include adequate screening criteria to eliminate unnecessary results and/or to more narrowly define a search in order to generate sufficient results. The screening criteria and any changes should be documented and the protocol should be re-assessed regularly (i.e., quarterly) in order to determine if any modifications are appropriate.

Recommendation 3:

The Office of Compliance Inspections and Examinations (“OCIE”) should establish a protocol that explains how to identify red flags and potential violations of securities law based on an evaluation of information found in news reports and relevant industry sources. The protocol should also determine how decisions on whether to initiate cause examinations are made and by whom, set a reasonable time frame for evaluation (i.e., 90 days) of the search results and provide notification to OCIE management when such time has expired.

Recommendation 4:

In accordance with the findings of the Center for Enterprise Modernization project and prior to its completion, the Office of Compliance Inspections and Examinations (“OCIE”) should implement an OCIE-related collection system that adequately captures information relating to the nature and source of each tip or complaint and also chronicles the vetting process to document why each tip or

complaint was or was not acted upon and who made that determination. All OCIE examiners should be given access to the system in order to be able to timely view and monitor tips and complaints that may be relevant to examinations they are preparing to conduct or are actively conducting. In addition, OCIE examiners should be given adequate access to tips and complaints received by the newly-created Office of Market Intelligence and other relevant sources such as the Office of Investor Education and Advocacy.

Recommendation 5:

The Office of Compliance Inspections and Examinations (“OCIE”) should annually review and test the effectiveness of its policies and procedures with regard to its tip and complaint collection system. OCIE should also modify these policies and procedures, where needed.

Recommendation 6:

Tips and complaints reviewed by the Office of Compliance Inspections and Examinations that appear on the surface to be credible and compelling should be probed further by in-depth interviews with the sources to assess their validity and to determine if there are other issues that need to be investigated. Any apparent contradictions in tip or complaint information need to be resolved as early as possible in the examination process through interviews with appropriate sources or further independent research. Findings from such interviews should be adequately documented and should be required reading for examination team members.

Recommendation 7:

All Office of Compliance Inspections and Examinations (“OCIE”)-related tips and/or complaints that are not vetted within 30 days of receipt should be brought to the attention of the OCIE Director with an explanation for the delay. All OCIE-related tips and/or complaints that merit a cause examination for which that examination does not begin within 60 days of receipt (a “Post-60 Day Examination”) must be reported to the OCIE Director with a monthly tally of yet-to-be-opened Post-60 Day Examinations sent to the Securities and Exchange Commission Chairman.

Recommendation 8:

All potentially relevant information received by the Office of Compliance Inspections and Examinations from a tip or complaint source should be preserved as a complete unit and should be augmented with relevant information that may have been provided in subsequent submissions by that source. Once

an examination has been initiated, such information should be required reading for examination team members.

Recommendation 9:

The Office of Compliance Inspections and Examinations (“OCIE”) should augment its policies and procedures related to the use of scope memoranda to better reflect particular consideration given to information collected as the result of tips and complaints that lead to cause examinations. When all potentially relevant tip and complaint source data, background information and research have been collected into one complete unit (see Recommendation 8), examination staff should identify all relevant potential securities law violations and other concerns and then prepare a planning memorandum that ties each and every potential violation and issue into the scoping discussion in the memorandum. The Planning Memorandum should include the basic steps that need to be taken in order to address the issues identified in the scope discussion. The Planning Memorandum should be reviewed, approved and signed (or initialed) by senior OCIE management (i.e., assistant director level or higher) and should include the names of the individuals who prepared and reviewed the document.

Recommendation 10:

The Office of Compliance Inspections and Examinations (“OCIE”) should timely modify or append the scope memorandum when significant new facts and issues emerge. The modified or supplemental scoping memorandum should be reviewed, approved and signed (or initialed) by senior OCIE management (i.e., assistant director level or higher) and should include the names of the individuals who prepared and reviewed the document.

Recommendation 11:

After examination scoping provisions have been approved, along with all other elements of the Planning Memorandum, the Planning Memorandum should be subjected to concurring review by an unaffiliated Office of Compliance Inspections and Examinations (“OCIE”) associate or assistant director (“Concurring Director Review”), and the person performing the Concurring Director Review should also recommend additional concurring reviews from the Commission’s Office of Economic Analysis, Office of Chief Accountant or other offices or divisions of the Commission as needed. All concurring reviewers should sign off on the Planning Memorandum indicating their approval and add any comments on the proposed scope or other areas discussed in the memorandum.

Recommendation 12:

After the Planning Memorandum is first drafted, it should be circulated to all examination team members, and all team members should then meet, in person or electronically, to discuss the examination approach and methodology set out in the memorandum, as well as any other issues the team members wish to raise.

Recommendation 13:

The examination team leader should ensure that all steps of the examination methodology, as stated in the Planning Memorandum, are completed and either the team leader or the appropriate team member should sign off on each step as it is completed.

Recommendation 14:

Substantive interviews conducted by the Office of Compliance Inspections and Examinations (“OCIE”) of registrants and third-parties during OCIE’s pre-examination activities and during the course of an active examination should be documented with notes circulated to all team members. After each substantive interview during the examination, the team leader should re-evaluate the examination scope and methodology as set out in the Planning Memorandum to determine if the examination needs to be expanded and indicate by initialing the interview notes that the team leader has performed that evaluation.

Recommendation 15:

The workpapers for a given examination should be in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues.²⁶

Recommendation 16:

When logging all Office of Compliance Inspections and Examinations examinations into an examination tracking system, the team leader should verify that the appropriate entry is made into the tracking system and, with a notation in

²⁶ This requirement for work paper documentation is taken from the objectives of audit work paper documentation for public company audits adopted by the Public Company Accounting Oversight Board as expressed on paragraph 4 of Auditing Standard 3:

Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues. [Footnote omitted.]

the Planning Memorandum, indicate that such entry has been made with the team leader's initials.

Recommendation 17:

The Office of Compliance Inspections and Examinations should annually review and test the effectiveness of its policies and procedures with regard to conducting, documenting and concluding its examinations²⁷ and modify the policies and procedures, where needed.

Recommendation 18:

The focus of an examination should drive the selection of the examination team and team members should be selected based upon their expertise related to such focus. There should also be a clearly defined examination team leader. Staffing decisions should be made by senior Office of Compliance Inspections and Examinations management (assistant director level or higher) after management has performed adequate pre-examination preparation so that management can make appropriate choices. The examination team should not be selected solely based on availability.

Recommendation 19:

Senior Office of Compliance Inspections and Examinations ("OCIE") management should ensure that personnel with the appropriate skills and expertise are assigned to cause examinations with unique or discrete needs (i.e., options expertise). OCIE should regularly seek out the appropriate expertise from other offices or divisions within the SEC and encourage intra-agency collaboration wherever possible.

Recommendation 20:

The Office of Compliance Inspections and Examinations should assign a Branch Chief, or a similarly designated lead manager, on every substantive project including all cause examinations. The Branch Chief or designated lead manager must be onsite or in direct communication with the onsite staff daily during the onsite portion of the examinations. Lower lever or junior staff examiners must not be left unsupervised during substantive discussions with principals or senior executives at the registrant during the examination.

²⁷ Similarly, investment firms are required to develop and implement policies and procedures designed to guide their securities activities and detect and prevent violative conduct. Broker Dealer policies and procedures must be reviewed for adequacy on an annual basis – see FINRA Rule 3130(b). Investment advisers must conduct an annual review of their policies and procedures – see Investment Advisers Act of 1940 Rule 206(4)-7(b).

Recommendation 21:

The Office of Compliance Inspections and Examinations (“OCIE”) should develop a formal plan with specific goals associated with achieving and maintaining professional designations and/or licenses by industry certification programs that are relevant to the examination activities conducted by OCIE. For instance, within the next three years, 50% of OCIE staff and management associated with examination activities should be qualified by means of a certification applicable to their profession such as the Association of Certified Fraud Examiners’ Certified Fraud Examiner designation, the American Institute of Certified Public Accountants’ Certified in Financial Forensics designation and/or the FINRA General Securities Principal license required of investment professionals.²⁸ These should include an annual continuing education component for each of these licenses.

Recommendation 22:

The Office of Compliance Inspections and Examinations (“OCIE”) should develop and implement interactive exercises to be administered by OCIE training staff or an independent third party and reviewed prior to hiring new OCIE employees in order to evaluate the relevant skills necessary to perform examinations. Similar exercises should be annually administered to all active examination staff and management in order to identify areas that need further development.

Recommendation 23:

Subject to approval of the examination team leader, Office of Compliance Inspections and Examinations (“OCIE”) examiners should contact clients of a BD or IA when necessary to confirm statements made by BD or IA personnel. Examiners should be encouraged to verify representations of third parties by contacting such parties, and appropriate methods used to contact third parties should become a part of OCIE’s training of examiners.

Recommendation 24:

In the course of an examination, if an examiner becomes aware of a potential securities law violation at another firm, that examiner should consult with the

²⁸ The investment firms that OCIE examines are required to have their professionals qualified by exam to perform securities investment activities. OCIE professionals should have a similar requirement in order to review and examine those activities. The FINRA General Securities license consists of the Series 7 and 24 courses covering the sales of securities and the supervision of such sales. The study materials are readily available from several providers. While OCIE examiners may not be able to sit for certain exams and obtain certain licenses due to their status as government employees, they are still able to obtain and study the course materials.

team leader and the Office of Compliance Inspections and Examinations should make a referral to the appropriate personnel or agency.

Recommendation 25:

The Office of Compliance Inspections and Examinations examiners should be trained in the mechanics of securities settlement, both in the U.S. and in major foreign markets.

Recommendation 26:

The Office of Compliance Inspections and Examinations (“OCIE”) examiners should be trained by the Office of International Affairs (“OIA”) in methods to access the expertise of foreign regulators, such as the United Kingdom’s Financial Services Authority, as well as foreign securities exchanges and foreign clearing and settlement entities. OCIE examiners should also be trained by OIA in methods to request and receive information pursuant to SEC Memoranda of Understanding with those foreign regulators. OCIE in conjunction with OIA should develop templates for the most frequent types of requests (i.e., sample trade data) from foreign regulators based on past experience in order to facilitate the process. OCIE in conjunction with OIA should develop and utilize contact lists with such regulators for use by appropriate examination staff.

Recommendation 27:

For significant issues such as whether trades have been executed and who has custody of assets, in the absence of third party (counterparties, custodians, etc.) documentation, the Office of Compliance Inspections and Examinations (“OCIE”) examiners should not simply rely on representations of BD or IA personnel but should contact third parties directly. OCIE should provide guidance or training that clarifies for examiners circumstances that require such contact with third parties.

Recommendation 28:

The Office of Compliance Inspections and Examinations examination staff should be required to verify a test sample of trading or balance data with counterparties and other independent third parties such as Financial Industry Regulatory Authority, Depository Trust Company, or National Securities Clearing Corporation whenever there are specific allegations of fraud involved in an examination.

Recommendation 30:

The Office of Compliance Inspections and Examinations staff should be given direct access to certain databases maintained by self-regulatory organizations or other similar agencies in order to allow examiners to access necessary data for verification or analysis of registrant data. Such databases should include exchange trading execution data, Depository Trust Company / National Securities Clearing Corporation data, the Financial Industry Regulatory Authority (“FINRA”) Order Audit Trail System and the FINRA Central Registration Depository.

Recommendation 31:

When an examination team is pulled off the examination for a project of higher priority, upon completion of that project, the examination team should return to their examination and bring the examination to a conclusion.

Recommendation 32:

One person in The Office of Compliance Inspections and Examinations (“OCIE”) should be responsible for tracking the progress of all cause examinations, and the tracking should include the number of cause examinations opened, the number on-going and the number closed for each month. Such data should be reported at least quarterly to the OCIE Director and to the Securities and Exchange Commission (“SEC”) Chairman. Any cause examinations open for more than 180 days should be reported to the OCIE Director and the SEC Chairman with an explanation as to why the examination requires more time.

Recommendation 33:

The Office of Compliance Inspections and Examinations’ policies and procedures should clearly indicate that at the conclusion of each examination, the examination team must prepare a closing report (“Closing Memorandum”) that begins with the scope discussion from the Planning Memorandum, as modified by new issues that arise during the course of the examination. For each and every issue discussed in the scoping discussion in the Planning Memorandum, the Closing Memorandum should provide findings relevant to each issue and state the team’s conclusions. All members of the examination team should sign the Closing Memorandum.

Recommendation 34:

Examination staff should not leave open any substantive issue without providing a sufficient basis for such a determination or a plan to pursue that issue at an appropriate later time. In the event that issues are unresolved or cannot be pursued further, examination staff should formerly refer those issues to the appropriate Securities and Exchange Commission staff that may further investigate and resolve such issues.

Recommendation 35:

The Office of Compliance Inspections and Examinations (“OCIE”) training should include instruction on personal liability, if any, assumed on the part of examiners for their actions in the course of performing their duties for OCIE.

Recommendation 36:

Office of Compliance Inspections and Examinations (“OCIE”) management should make clear that it will support OCIE examiners in their pursuit of evidence in the course of an examination, even if pursuing that evidence requires contacting customers or clients of the target of that examination.

Recommendation 37:

When an auditor’s independence is questioned in a tip or complaint, the Office of Compliance Inspections and Examinations should report the information, if deemed credible, to the appropriate state board of accountancy and to the Public Company Accounting Oversight Board, if applicable, in addition to considering a referral to the Securities and Exchange Commission’s Enforcement Division or other government agency.

Management Comments

MEMORANDUM

TO: David Kotz
Inspector General, Office of Inspector General

FROM: John Walsh
Acting Director, Office of Compliance Inspections and Examinations 

RE: Office of Compliance Inspections and Examinations' Response to the Office of Inspector General's Report, *Findings and Recommendations Report of FTI Consulting, Inc.*

DATE: September 23, 2009

I. Introduction

The Office of Compliance Inspections and Examinations ("OCIE") submits this memorandum in response to the Office of Inspector General's ("OIG") draft report entitled *Findings and Recommendations Report of FTI Consulting, Inc.* ("Report"). Thank you for the opportunity to respond to the Report.

OCIE has fully cooperated with the audit by the OIG and FTI Consulting, Inc. ("FTI"). We have provided the FTI team access to numerous OCIE records, including registrant communications, examination work papers, and other records of a highly sensitive and non-public nature. We appreciate the OIG's and FTI's understanding regarding the sensitive nature of these documents.

You have requested that we indicate whether we "concur" or "non-concur" with each recommendation. In no case do we "non-concur." However, several of the recommendations directed to OCIE will require the deployment of significant staff resources or the resolution of antecedent policy issues. In those cases we have indicated that we agree with the principal of the recommendation and describe the steps we will take to follow-up on your recommendation. Otherwise, we state that we "concur" and describe how we intend to implement your recommendation.

II. Recommendations Directed to OCIE

Recommendation 1: *OCIE should provide all examiners access to relevant industry publications (i.e., MAR/Hedge-type publications) and third-party database subscriptions sufficient to develop examination leads and stay current with industry trends. OCIE should regularly (i.e., quarterly) assess whether they have adequate access to relevant industry publications and other such sources (newsletter, independent subscription-type news alerts, etc.) and make reasonable attempts to gain such access.*

OCIE concurs with this recommendation. The SEC already subscribes to a wide range of relevant industry publications and third-party databases. These publications and databases assist

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examiners in remaining current on industry developments and in identifying trends and entities with unusual characteristics that warrant examiner oversight. Currently, due to cost considerations, access to a number of the third-party database subscriptions is limited to OCIE surveillance and risk assessment staff, who analyze the data and report to the rest of the staff. To implement this recommendation, we believe data intelligence rooms should be established within OCIE and each regional office.¹

Recommendation 2: *OCIE should establish a protocol for searching and screening news articles and information from relevant industry sources that may indicate securities law violations at broker-dealers and investment-advisers. The protocol should include flexible searching capability to help identify specific areas of risk or concern and should include access to all relevant industry publications. The protocol should also include adequate screening criteria to eliminate unnecessary results and/or to more narrowly define a search in order to generate sufficient results. The screening criteria and any changes should be documented and the protocol should be re-assessed regularly (i.e., quarterly) in order to determine if any modifications are appropriate.*

OCIE concurs with this recommendation. For several years, OCIE has been pursuing an electronic system that would include, among other things, the deployment of a battery of software tools that would continuously monitor the flow of information in the media, broadly defined to include traditional media as well as non-traditional media,² for any article or post that mentions a regulated entity or supervised persons associated with any such entity. The new system would risk-rank articles or posts based on potential investor harm, and the articles or posts ranked high risk would be promptly distributed to the regional office examination staff responsible for oversight of the identified entity for consideration of possible examination follow-up.³ This electronic system would capture and store all articles and posts identified, and the database of captured information would be fully searchable by examination staff. We have been working on this electronic system for several years but have lacked sufficient funding to finalize and implement it.⁴

Recommendation 3: *OCIE should establish a protocol that explains how to identify red flags and potential violations of securities law based on an evaluation of information found in news*

¹ We believe that it would require additional funding of approximately \$300 to \$400 thousand annually to make the relevant databases available to the entire examination staff, by establishing a data intelligence room within OCIE and each regional office, although licensing requirements for several databases may require that every examiner have their own license which would significantly increase the cost of such access.

² Non-traditional media would include blogs, Twitter and other social networking sites, and other media associated with Web 2.0 developments.

³ This database in conjunction with all of the other intelligence resources available to examiners would greatly enhance examiners ability to identify activities of firms and funds that should receive special attention during both cause and scheduled examinations.

⁴ We estimate that full implementation of this system would cost at least \$3 to 4 million with additional costs for software license and hardware upgrades, as well as associated staffing needs.

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reports and relevant industry sources. The protocol should also determine how decisions on whether to initiate cause examinations are made and by whom, set a reasonable time frame for evaluation (i.e., 90 days) of the search results and provide notification to OCIE management when such time has expired.

OCIE concurs with this recommendation. We have drafted protocols to provide additional guidance to examiners on identifying conflicts of interest and other red flags that might be indicia of fraud, and plan to implement these modules in the next fiscal year. These new protocols will supplement OCIE's current examination modules that address various other types of potential securities law violations, and will provide guidance to examiners in their pre-examination surveillance, planning, and preparation work. We will also draft a written protocol describing the process by which examination managers determine whether a cause examination should be initiated and the time frame in which such determinations should be made and implemented.

Recommendation 4: *In accordance with the findings of the Center for Enterprise Modernization project and prior to its completion, OCIE should implement an OCIE-related collection system that adequately captures information relating to the nature and source of each tip or complaint and also chronicles the vetting process to document why each tip or complaint was or was not acted upon and who made that determination. All OCIE examiners should be given access to the system in order to be able to timely view and monitor tips and complaints that may be relevant to examinations they are preparing to conduct or are actively conducting. In addition, OCIE examiners should be given adequate access to tips and complaints received by the newly-created Office of Market Intelligence and other relevant sources such as the Office of Investor Education and Advocacy.*

OCIE agrees that a centralized database for tracking relevant information related to tips and complaints will be a significant benefit to the examination program, and we look forward to deployment of the new SEC-wide tips, complaints, and referrals system currently under development. However, we do not believe that it would be appropriate to expend resources to establish a sophisticated OCIE-specific tips and complaints database system that ultimately might not be compatible with the SEC-wide system currently being developed under Chairman Schapiro's leadership. In the interim, we will modify the internal processes and tracking system OCIE currently relies on to track tips and complaints submitted to examination staff to ensure we are capturing the above-recommended information.

Recommendation 5: *OCIE should annually review and test the effectiveness of its policies and procedures with regard to its tip and complaint collection system. OCIE should also modify these policies and procedures, where needed.*

OCIE concurs with this recommendation. We agree that it is important to periodically evaluate the effectiveness of policies and procedures related to tips and complaints. As noted above, we look forward to the deployment of the new SEC-wide system for tracking tips and complaints. In the interim, we will review OCIE's current procedures for handling tips and complaints and modify them as necessary to ensure they are effective.

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Recommendation 6: *Tips and complaints reviewed by OCIE that appear on the surface to be credible and compelling should be probed further by in-depth interviews with the sources to assess their validity and to determine if there are other issues that need to be investigated. Any apparent contradictions in tip or complaint information need to be resolved as early as possible in the examination process through interviews with appropriate sources or further independent research. Findings from such interviews should be adequately documented and should be required reading for examination team members.*

OCIE concurs with this recommendation. The new protocols described above in response to Recommendation 3, along with OCIE's procedures for handling complaints and tips, will address the items noted in this recommendation.

Recommendation 7: *All OCIE-related tips and/or complaints that are not vetted within 30 days of receipt should be brought to the attention of the OCIE Director with an explanation for the delay. All OCIE-related tips and/or complaints that merit a cause examination for which that examination does not begin within 60 days of receipt (a "Post-60 Day Examination") must be reported to the OCIE Director with a monthly tally of yet-to-be-opened Post-60 Day Examinations sent to the SEC Chairman.*

OCIE concurs with this recommendation. Specifically, we agree that tips and complaints should be vetted as promptly as possible. We will incorporate into OCIE's interim tips and complaints tracking process a field that permits us to track the number of days that have passed since the tip or complaint was submitted to the examination program, with reports to OCIE's Director at the points in time that you suggest. Further, we will bring these recommended items to the attention of the team working on the agency-wide tips, complaints and referrals system for their consideration. Finally, we have consulted with the Chairman's staff regarding your recommendation, and will include the information you recommend in our reports to the Chairman's Office.

Recommendation 8: *All potentially relevant information received by OCIE from a tip or complaint source should be preserved as a complete unit and should be augmented with relevant information that may have been provided in subsequent submissions by that source. Once an examination has been initiated, such information should be required reading for examination team members.*

OCIE concurs with this recommendation. We look forward to the deployment of the agency's new tips, complaints, and referrals system which will facilitate the management and tracking of information from tip or complaint sources. Further, the new protocols described above in response to Recommendation 3 will include required review of the information that led the staff to initiate the examination.

Recommendation 9: *OCIE should augment its policies and procedures related to the use of scope memoranda to better reflect particular consideration given to information collected as the result of tips and complaints that lead to cause examinations. When all potentially relevant tip and complaint source data, background information and research have been collected into one complete unit (see Recommendation 8), examination staff should identify all relevant potential*

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securities law violations and other concerns and then prepare a planning memorandum that ties each and every potential violation and issue into the scoping discussion in the memorandum. The Planning Memorandum should include the basic steps that need to be taken in order to address the issues identified in the scope discussion. The Planning Memorandum should be reviewed, approved, and signed (or initialed) by senior OCIE management (i.e., assistant director or higher) and should include the names of individuals who prepared and reviewed the document.

OCIE concurs with this recommendation. We have already updated OCIE's Examination Scope Memorandum guidance to address examinations resulting from complaints or tips, and to require that the scope memorandum discuss and document any decision to reduce the scope of the examination to less than the full scope of the complaint or tip.

Recommendation 10: *OCIE should timely modify or append the scope memorandum when significant new facts and issues emerge. The modified or supplemental scoping memorandum should be reviewed, approved and signed (or initialed) by senior management (i.e. assistant director level or higher) and should include the names of the individuals who prepared and reviewed the document.*

OCIE agrees it is important to ensure that examiners have the flexibility to quickly modify the scope of an examination as soon as new information comes to light, and to seek supervisory approval as they do so. We also recognize the importance of documenting any significant changes to the scope of an examination. To follow-up on this recommendation, we will communicate to examiners that they should modify the scope of an examination when significant new facts or issues emerge, and promptly seek oral supervisory approval of any such change. At the same time, to ensure that examiners have the flexibility to move quickly in response to new evidence, we will defer formal written documentation of the scope change and supervisory approval until the report-writing stage of the examination.

Recommendation 11: *After examination scoping provisions have been approved, along with all other elements of the Planning Memorandum, the Planning Memorandum should be subjected to concurring review by an unaffiliated OCIE associate or assistant director ("Concurring Director Review"), and the person performing the Concurring Director Review should also recommend additional concurring reviews from the Commission's Office of Economic Analysis, Office of Chief Accountant or other offices or divisions of the Commission as needed. All concurring reviewers should sign off on the Planning Memorandum indicating their approval and add any comments on the proposed scope or other areas discussed in the memorandum.*

OCIE agrees that having a second supervisor involved in the management of an examination could be helpful and appropriate in certain circumstances. However, requiring involvement by a second Associate Director would be very difficult because many regional offices have only a single Associate Director for examinations. Moreover, given that the SEC conducts more than two thousand examinations a year, and that cause examinations should start as soon as possible, we worry that a mandatory concurring review approach at the scope memorandum stage would be cumbersome and would cause delays. To follow-up on this recommendation, we will work to involve additional examination managers in the oversight of examinations, such as, for example,

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by including more than one Assistant Director in Quarterly Reviews of open examinations.⁵ Requiring the participation of additional Assistant Directors will help integrate the program as well as provide a check-and balance. Finally, an important element of the Quarterly Review is to determine whether additional expertise is required to conduct the examination. In sum, we believe having a second Assistant Director participate in Quarterly Reviews will provide an enhanced check and balance, as it will encompass management of the overall examination, not simply the drafting of the scope memorandum.

Recommendation 12: *After the Planning Memorandum is drafted, it should be circulated to all examination team members, and all team members should then meet, in person or electronically, to discuss the examination approach and methodology set out in the memorandum, as well as any other issues the team members wish to raise.*

OCIE concurs with this recommendation. The new protocols described above in response to Recommendation 3 will include this requirement.

Recommendation 13: *The examination team leader should ensure that all steps of the examination methodology, as stated in the Planning Memorandum, are completed and either the team leader or the appropriate team member should sign off on each step as it is completed.*

OCIE concurs with this recommendation. The new protocols described above in response to Recommendation 3 will include this requirement.

Recommendation 14: *Substantive interviews conducted by OCIE of registrants and third parties during OCIE's pre-examination activities and during the course of an active examination should be documented with notes circulated to all team members. After each substantive interview during the examination, the team leader should re-evaluate the examination scope and methodology as set out in the Planning Memorandum to determine if the examination needs to be expanded and indicate by initialing the interview notes that the team leader has performed that evaluation.*

OCIE concurs with this recommendation. The new protocols described above in response to Recommendation 3 will include this requirement. We note, however, that the protocols will give examination teams the flexibility to discuss interviews orally, instead of through the circulation of written notes. This reflects the reality that small teams examining small firms will not require the formality suggested in your recommendation. We also agree that the examination team leader or branch chief should regularly consider whether an examination scope should be expanded or narrowed and that significant changes to the scope of an examination should be timely documented and ultimately approved by an examination manager in the report.

⁵ We note that OCIE's existing protocol for conducting examination sweeps provides for an extensive review and comment process. Before embarking on an examination sweep, OCIE senior managers prepare an Information Memorandum that details the scope of the proposed examinations and the reason for the sweep, obtain comments on the Memorandum from relevant SEC Divisions and/or Offices, and submit the Memorandum to the Commission for its review and information.

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Recommendation 15: *The work papers for a given examination should be in sufficient detail to provide a clear understanding of its purpose, source, and the conclusion reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues.*

OCIE concurs with this recommendation. We note that OCIE implemented enhanced procedures in July 2008 describing the appropriate organization and content of examination work papers, addressing the accurate identification of documents retained as work papers, and requiring supervisory review of such work papers.

Recommendation 16: *When logging all OCIE examinations into an examination tracking system, the team leader should verify that the appropriate entry is made into the tracking system and, with a notation in the Planning Memorandum, indicate that such entry has been made with the team leader's initials.*

OCIE concurs with this recommendation. The new protocols described above in response to Recommendation 3 will include this requirement.

Recommendation 17: *OCIE should annually review and test the effectiveness of its policies and procedures with regard to conducting, documenting and concluding its examinations and modify the policies and procedures, where needed.*

OCIE concurs with this recommendation. An annual review of the effectiveness of existing policies and procedures would be an important tool in managing the examination program. We note, however, that an annual review of all procedures would require the commitment of significant resources and staff. We anticipate that, because such a commitment depends so heavily on resources, it could take approximately two years to fully implement this recommendation. We will submit a plan of action to the Chairman that will include options, recommendations, and the resources and staff that will likely be necessary.

Recommendation 18: *The focus of an examination should drive the selection of the examination team and team members should be selected based upon their expertise related to such focus. There should also be a clearly defined examination team leader. Staffing decisions should be made by senior OCIE management (assistant director level or higher) after management has performed adequate pre-examination preparation so that management can make appropriate choices. The examination team should not be selected solely based on availability.*

OCIE concurs with this recommendation. The recently created Senior Specialized Examiner positions will provide greater flexibility to examination managers to match staff skills and expertise to specific examination issues. In addition, the new protocols described above in response to Recommendation 3 will include guidance on staffing decisions.

Recommendation 19: *Senior OCIE management should ensure that personnel with the appropriate skills and expertise are assigned to cause examinations with unique or discrete needs (i.e., options expertise). OCIE should regularly seek out the appropriate expertise from*

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other offices or divisions within the SEC and encourage intra-agency collaboration wherever possible.

OCIE concurs with this recommendation. As stated above in response to recommendation 18, the recently created Senior Specialized Examiner positions will provide greater flexibility to examination managers to match staff skills and expertise to specific examination issues. We also agree that collaboration with staff in other SEC Offices and Divisions is helpful to address unique examination issues. As stated above, an important focus of the Quarterly Review of all open examinations is to determine if the examination could benefit from the deployment of new skills.

Recommendation 20: *OCIE should assign a branch chief, or a similarly designated lead manager, on every substantive project including all cause examinations. The branch chief or designated lead manager must be onsite or in direct communication with the onsite staff daily during the onsite portion of the examinations. Lower level junior staff examiners must not be left unsupervised during substantive discussions with principals or senior executives at the registrant during the examination.*

OCIE concurs with this recommendation. OCIE will reiterate its policy requiring branch chiefs to be in regular communication with the examination lead during the onsite portions of examinations where the branch chief is not also onsite. OCIE will also remind examination managers that junior examiners should not hold unsupervised substantive discussions with senior executives of a registrant during an examination.⁶

Recommendation 21: *OCIE should develop a formal plan with specific goals associated with achieving and maintaining professional designations and/or licenses by industry certification programs that are relevant to the examination activities conducted by OCIE. For instance, within the next three years, 50% of OCIE staff and management associated with examination activities should be qualified by means of a certification applicable to their profession such as the Association of Certified Fraud Examiners' Certified Fraud Examiner designation, the American Institute of Certified Public Accountants' Certified in Financial Forensics designation and/or the FINRA General Securities Principal license required of investment professionals. These should include an annual continuing education component for each of these licenses.*

OCIE concurs with this recommendation, except as noted in the paragraph below. Training plays an important role in helping examination staff increase and/or maintain relevant expertise and skills. Currently, more than 40% of all examination staff have been certified or have enrolled in programs leading to certifications such as: Certified Fraud Examiner, Chartered Financial Analyst, and Chartered Alternative Investment Analyst. We will consult with the Chairman regarding the SEC's ability to cover the costs of any continuing education component associated with such professional certifications or licenses.

⁶ We note that OCIE's current policies provide that examinations should not be conducted by a solo examiner, except in exceptional circumstances, and not by a junior examiner.

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As noted in a footnote in the Report, SEC staff may not obtain FINRA General Securities Principal licenses. FINRA requires an individual to be affiliated with an SEC-registered entity in order to become so licensed. Further, FINRA does not permit an individual to "park" a FINRA General Securities Principal license. OCIE has, however, provided training to examiners on the materials covered by the test for certain FINRA licenses, such as Series 55 and Series 7, and agrees that such training should be made available to examiners, cost permitting, going forward.

Recommendation 22: *OCIE should develop and implement interactive exercises to be administered by OCIE training staff or an independent third party and reviewed prior to hiring new OCIE employees in order to evaluate the relevant skills necessary to perform examinations. Similar exercises should be annually administered to all active examination staff and management in order to identify areas that need further development.*

OCIE agrees that interactive exercises, including technology-based programs, would be beneficial for training examiners. We understand that the U.S. Army, healthcare organizations, and other industries have already developed and implemented gaming technology for training and other purposes, with good results. To follow-up on this recommendation we anticipate submitting a plan of action to the Chairman that will include options, recommendations, and the resources that will likely be necessary to deploy this program for existing staff. We will consider whether these methods could potentially be deployed in the recruiting process; however, any requirement that potential employees pass a test raises a number of issues that must be carefully considered.

Recommendation 23: *Subject to approval of the examination team leader, OCIE examiners should contact clients of a BD or IA when necessary to confirm statements made by BD or IA personnel. Examiners should be encouraged to verify representations of third parties by contacting such parties, and appropriate methods used to contact third parties should become a part of OCIE's training of examiners.*

OCIE concurs with this recommendation. We have already made third-party verification a routine aspect of the examination program and plan to provide training to all examiners in the fall on third-party asset-verification techniques.

Recommendation 24: *In the course of an examination, if an examiner becomes aware of a potential securities law violation at another firm, that examiner should consult with the team leader and OCIE should make a referral to the appropriate personnel or agency.*

OCIE concurs with this recommendation. The new protocols described above in response to Recommendation 3 will include this requirement.

Recommendation 25: *OCIE examiners should be trained in the mechanics of securities settlement, both in the U.S. and in major foreign markets.*

OCIE concurs with this recommendation. For the past several years, OCIE has provided training to examiners on the mechanics of securities settlement. OCIE did not, however, provide such

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training in the past fiscal year due to budget limitations. OCIE plans to offer this training to all examiners on a regular basis going forward.

Recommendation 26: *OCIE examiners should be trained by the Office of International Affairs ("OIA") in methods to access the expertise of foreign regulators, such as the United Kingdom's Financial Services Authority, as well as foreign securities exchanges and foreign clearing and settlement entities. OCIE examiners should also be trained by OIA in methods to request and receive information pursuant to SEC Memoranda of Understanding with those foreign regulators. OCIE in conjunction with OIA should develop templates for the most frequent types of requests (i.e., sample trade data) from foreign regulators based on past experience in order to facilitate the process. OCIE in conjunction with OIA should develop and utilize contact lists with such regulators for use by appropriate examination staff.*

OCIE concurs with this recommendation. We agree that examiners should understand the expertise and services offered by OIA staff, including the methods OIA staff use to contact foreign entities, such as foreign regulators, foreign domiciled entities, foreign exchanges, and foreign clearing entities. OIA currently maintains a list of contacts at foreign regulatory agencies and OIA staff best understands the methods pursuant to which foreign regulators should be approached, including pursuant to Memoranda of Understanding. Nonetheless, we concur that training on OIA's processes will enhance examiners' interaction with OIA and the effectiveness of their examinations. Further, OIA, in conjunction with OCIE, has developed templates for the most common types of examination requests to foreign regulators and entities. To follow-up on this recommendation, we anticipate including OIA in training for examiners, and generally working to enhance our cooperation, including providing guidance on when examination staff may directly contact a foreign entity, and when the contact should be handled by OIA.

Recommendation 27: *For significant issues such as whether trades have been executed and who has custody of assets, in the absence of third party (counterparties, custodians, etc.) documentation, OCIE examiners should not simply rely on representations of BD or IA personnel but should contact third parties directly. OCIE should provide guidance or training that clarifies for examiners circumstances that require such contact with third parties.*

OCIE concurs with this recommendation. As noted above in response to Recommendation 23, OCIE has already made third-party verification a routine aspect of the examination program, and plans to provide additional training on third-party asset-verification techniques to all examiners in the fall.

Recommendation 28: *OCIE examination staff should be required to verify a test sample of trading or balance data with counterparties and other independent third parties such as FINRA, DTC, or NSCC whenever there are specific allegations of fraud involved in an examination.*

OCIE concurs with this recommendation. As noted above, OCIE has already made third-party verification a routine aspect of the examination program. At the additional training to be offered on third-party verification this fall, examiners will be trained on appropriate techniques to use when there are specific allegations of fraud.

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Recommendation 29: *OCIE examiners should be trained jointly with the Office of Economic Analysis ("OEA") economists by FINRA, other self-regulatory organizations ("SROs") and exchange staff in understanding the trading databases provided by FINRA, NASDAQ/OMX, the NYSE/ARCA/AMEX, regional exchanges, OCC, option exchanges, and DTCC/NSCC, etc. As trading and trading venues change over time, the OCIE training should be recurring and updated.*

OCIE concurs with this recommendation. At the additional training to be offered on third-party verification this fall, examiners will be trained in understanding and using the trading databases provided by the entities identified in your recommendation.

Recommendation 30: *OCIE staff should be given direct access to certain databases maintained by SROs or other similar agencies in order to allow examiners to access necessary data for verification or analysis of registrant data. Such databases should include exchange trading execution data, DTC/NSCC data, the FINRA Order Audit Trail System ("OATS") and the FINRA Central Registration Depository ("CRD").*

OCIE agrees that direct access to SRO databases would be helpful. All examiners currently have direct desktop access to the FINRA CRD database. In addition, examiners can obtain certain trading information, with the exception of execution time, from the SEC's Blue Sheet database. However, examiners currently have to request detailed trading data (e.g., OATS, TRACE) from FINRA, which it extracts from various databases, or other SROs. OCIE supports an initiative to provide examiners with direct access to this important data, although there may be substantial costs associated with our obtaining direct access.

Recommendation 31: *When an examination team is pulled off the examination for a project of higher priority, upon completion of that project, the examination team should return to their examination and bring it to a conclusion.*

OCIE concurs with this recommendation. The new protocols described above in response to Recommendation 3 will include this requirement.

Recommendation 32: *One person in OCIE should be responsible for tracking the progress of all cause examinations, and the tracking should include the number of cause examinations opened, the number on-going and the number closed for each month. Such data should be reported at least quarterly to the OCIE Director and the SEC Chairman. Any cause examinations open for more than 180 days should be reported to the OCIE Director and the SEC Chairman with an explanation as to why the examination requires more time.*

OCIE concurs with this recommendation. The database OCIE currently uses to track all examination information identifies cause examinations and tracks the examination start date and resolution date. OCIE currently reports select information regarding progress and results of examinations to the Director of OCIE and the Chairman, on a monthly basis. OCIE will modify this report to identify all cause examinations open for more than 180 days as of the date of the report and the reason they have not been resolved. OCIE notes that care must be taken, however, to ensure examiners do not feel pressured to close examinations early as a result of this report.

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Recommendation 33: *OCIE's policies and procedures should clearly indicate that at the conclusion of each examination, the examination team must prepare a closing report ("Closing Memorandum") that begins with the scope discussion from the Planning Memorandum, as modified by new issues that arise during the course of the examination. For each and every issue discussed in the scoping discussion in the Planning Memorandum, the Closing Memorandum should provide findings relevant to each issue and state the team's conclusions. All members of the examination team should sign the Closing Memorandum.*

OCIE concurs with this recommendation. OCIE's current procedures require that a report or closing memorandum be completed at the conclusion of every examination and that the report include a cover page signed by each examiner and the two examination managers that reviewed and approved the examination report. OCIE will remind examination managers of this requirement and take steps to help ensure all team members sign the examination report or closing memorandum.

Recommendation 34: *Examination staff should not leave open any substantive issue without providing a sufficient basis for such a determination or a plan to pursue that issue at an appropriate later time. In the event that issues are unresolved or cannot be pursued further, examination staff should formerly refer those issues to the appropriate SEC staff that may further investigate and resolve such issues.*

OCIE concurs with this recommendation. The new protocols described above in response to Recommendation 3 will include this requirement.

Recommendation 35: *OCIE training should include instruction on personal liability, if any, assumed on the part of examiners for their actions in the course of performing their duties for OCIE.*

OCIE concurs with this recommendation. OCIE will incorporate a session on personal liability into its ethics training video that all new examiners must watch, as well as into its mandatory annual refresher ethics course for all examination staff.

Recommendation 36: *OCIE management should make clear that it will support OCIE examiners in their pursuit of evidence in the course of an examination, even if pursuing that evidence requires contacting customers or clients of the target of that examination.*

OCIE concurs with this recommendation. OCIE will reiterate its longstanding support of examiners pursuing relevant evidence during the course of an examination. OCIE will also remind all examiners of the importance of contacting clients or customers. OCIE has created standard documents for examiners to use when contacting an entity's clients or customers.

Recommendation 37: *When an auditor's independence is questioned in a tip or complaint, OCIE should report the information, if deemed credible, to the appropriate state board of accountancy and to the Public Company Accounting Oversight Board, if applicable, in addition to considering a referral to the SEC's Enforcement Division or other government agency.*

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OCIE concurs with this recommendation. We will coordinate with staff in the Office of the Chief Accountant about the appropriate referral of such issues to the Public Company Accounting Oversight Board or relevant state board of accountancy.

OIG Response to Management's Comments

The Office of Inspector General ("OIG") is pleased that the Office of Compliance Inspections and Examinations ("OCIE") concurred with all 37 recommendations in this report. We believe that these recommendations are crucial to ensuring that OCIE is able to conduct thorough and effective examinations in the future. As the OIG Report entitled "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme" dated August 31, 2009 detailed, OCIE received substantive complaints that raised significant red flags concerning Bernard L. Madoff's ("Madoff") hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. Moreover, the examinations that OCIE conducted of Madoff based upon these detailed and credible complaints were poorly planned and executed and were concluded while numerous open and unresolved questions remained.

We believe that the immediate implementation of these recommendations should be OCIE's top priority. We are encouraged that OCIE is acknowledging that significant changes are necessary in its operations and that it intends to implement all of our recommendations. We have some concerns that OCIE's responses to a few of the recommendations are vague or contain conditions, including some which are outside of OCIE's control such as resources or policy issues.

The strength of our capital markets relies on investor confidence, which in turn depends on vigorous regulatory oversight. The SEC oversees inspections and examinations of the key participants in the securities world, including securities exchanges, brokers, and investment advisers. Investors will only be confident in entrusting their savings with these entities when they have confidence that the SEC's oversight is vigorous and competent. As the OIG's Report of Investigation made clear, investors relied on SEC examinations in making investment decisions. Specifically, investors who were uncertain about whether to invest with Madoff were reassured by the fact that the SEC had conducted examinations of Madoff's firm and not detected fraud. Moreover, Madoff himself cited these examinations as evidence that he was not engaged in fraud. Thus, it is critical that OCIE engage in competent and thorough examinations, which, in our view, can be accomplished only by quickly implementing in full the recommendations in this report.

We believe that these recommendations would simply ensure a basic level of competence in OCIE examinations and can be fully implemented in short order. While we understand that OCIE believes that two of the 37 recommendations may require additional resources, we expect OCIE to immediately implement a substantial portion of the two recommendations and seek additional resources to assist in full compliance.

The OIG plans to follow-up to ensure that all 37 recommendations are implemented in full and report back to the Congress on the status of these efforts. We also plan to conduct a follow-up audit to determine if the changes to OCIE's operations are having the desired and appropriate effect.

A Detailed Trading Volume Analysis

The following is a more detailed description of the analysis performed by the FTI Engagement Team to verify BMIS' reported equity trading volume based on a sample of account statements and trade confirmations issued by BMIS to its feeder fund clients Kingate Management Ltd. ("Kingate") and Fairfield Sentry, Ltd. ("Fairfield") in 2005, in comparison to BMIS' trade reporting data submitted to the NASD, as well as its clearing and settlement records provided by NSCC, for U.S. executions. In addition, the FTI Engagement Team compared BMIS trade settlement records provided by DTC for January 2005 to overnight securities holdings shown in BMIS account statements. This exercise is meant to illustrate what the OCIE examination teams would have discovered had they conducted a similar analysis, which may also have, depending on its results, prompted the OCIE examination teams to pursue additional information on European trade executions.

Feeder Fund Account Statements and Trade Confirmations

The FTI Engagement Team has a sample of trading activity records as captured in the monthly account statements for two Kingate funds (Kingate Global Fund and Kingate Euro Fund) produced by BMIS from 2005: Kingate Euro Fund – January 2005, Kingate Global Fund – February 2005, Kingate Euro Fund – March 2005 and Kingate Global Fund – March 2005. Additionally, The FTI Engagement Team also has trade confirmations produced by BMIS to Fairfield from January 2005. These account statements and trade confirmations were acquired by the 2005 NERO Cause Examination team from BMIS in 2005.

The monthly account statements provide only basic information, i.e., they only include daily trading activities throughout the month without detailing either the investment position or the cash balance of the two fund portfolios at any given time. The trading activity records in the statements also do not show the execution time, the execution price or the trade date of each transaction. Only settlement dates and average daily prices of traded stocks are provided. Fairfield's trade confirmations, on the other hand, contain month-end securities position information in addition to daily trading activities.

For both Kingate funds, the account statements reveal that trading was centered on selected S&P 100 Index stocks with a daily buy and a daily (offsetting) sell for each of those stocks so that by the end of a trading day, all equity positions were closed out. For example, on March 10, 2005, BMIS executed buy and sell transactions for a total of 44 stocks selected from the S&P 100 Index list for each of the two Kingate funds (88 stock positions in total). For each stock, the monthly account statements show that BMIS first established either a long or a short

position on a given trading day, and then closed out the entire position by the end of the trading day so that no equity position was carried overnight.

Equity Trading – FINRA/NASD Database Comparison

The FTI Engagement Team understood that the 2004 OCIE Cause Examination had prepared a data request letter to the NASD but the letter was never sent. Based on that draft letter, during the current OIG investigation process, the FTI Engagement Team drafted a data request letter to FINRA's Market Regulation Department and asked for NASDAQ ACT (Automatic Confirmation of Transactions) data²⁹ and OATS (Order Audit Trail System) data for the relevant time period of March 2005 in relation to BMIS account statements for the two Kingate funds. In addition, at the FTI Engagement Team's request, OIG obtained data from NSCC for the same time period of 2005 and selected securities as the data provided by FINRA. The FTI Engagement Team has performed a review of trading volume based on the Kingate records provided by BMIS from March 2005, as well as actual relevant trading data provided by FINRA and NSCC for the same time period.

The trading data that would have been provided by NASD during the 2004 OCIE examination, the NASDAQ ACT data, however, had limitations in that most but not all trading activity for a given broker-dealer would bear that broker-dealer's name.³⁰ Instead of relying solely on NASD data, a better approach to analyze volume for U.S. trading would have been to contact NSCC,³¹ as data provided by NSCC is more comprehensive and should include most trades executed by broker-dealers. Regardless, the differences in reported volume between the NASDAQ ACT data and the NSCC data are insignificant when compared to the differences in total volume between those two databases and BMIS' reported volume to its feeder funds, as the FTI Engagement Team's charts below illustrate. An analysis performed on trading volume using either database would have likely resulted in uncovering a red flag during the examinations.³²

For the volume analysis, the FTI Engagement Team selected a sample of 14 stocks out of the total 44 stocks professed to be traded by BMIS from March 10 through March 15, 2005 (with the corresponding settlement dates from March 15 through March 18, 2005), a total of four trading days. Of the 14 stocks, 6 were

²⁹ Also known as the trade audit trail database.

³⁰ In the case of BMIS, some of the trades conducted through Electronic Communication Networks ("ECNs") or other exchanges by BMIS where BMIS was not a member firm were likely not captured by the NASDAQ ACT system.

³¹ FINRA, though, would still be the preferred source for data relating to front running, best execution and other trading issues.

³² The results based upon the NSCC data will be presented in the following section.

listed on NASDAQ, and 8 were listed on the NYSE.³³ The other 30 stocks not included in this analysis were all listed on the NYSE. The FTI Engagement Team first calculated the total share volume traded based on Kingate's account statements for each of the 14 stocks on each of the four trading days. The FTI Engagement Team then performed the same analysis using NASDAQ ACT and OATS data to sum up the total volume reported by BMIS for each stock on each trading day.³⁴

BMIS reported trades to the NASDAQ ACT system for both NASDAQ-listed and NYSE-listed issues. BMIS was a member firm of FINRA/NASD and NASDAQ; however, it was not a member firm of the NYSE. As a result, BMIS would trade NYSE-listed issues as a NASDAQ market maker and report trades to NASDAQ ACT, instead of to Securities Information Automation Corporation ("SIAC"), which handled NYSE member firms' reported trades.³⁵ In contrast, the NASDAQ's OATS system is only required for NASDAQ-listed issues. Therefore, using OATS, the FTI Engagement Team could only perform the volume analysis for the six NASDAQ-listed stocks included in the sample account statements as part of the S&P 100 Index stocks. OATS is designed so that every member firm of FINRA/NASDAQ would report their customer orders' final status, which includes execution, cancellation, replacement, expiration or being routed to another member firm for execution.³⁶

³³ The FTI Engagement Team first selected all six stocks listed on NASDAQ, then randomly selected another 8 stocks from a pool of 38 NYSE-listed stocks.

³⁴ For NASDAQ-listed stocks, all execution volume in OATS should also be reflected in ACT, either as tape-reported volume, or in the case of odd-lot trades (less than 100 shares), as clearing and settlement volume. Therefore, OATS is serving as a second check on the total reported volume to FINRA/NASD by BMIS for the six NASDAQ-listed stocks.

³⁵ Any BMIS trades that were "laid off" to NYSE member brokers and executed through the NYSE trading system were not captured by the ACT data, though they would have been captured by the NSCC database. However, the layoff volume is part of a market maker's proprietary volume; therefore, the layoff volume should not have explained the large discrepancy in volume between customers' account statements and ACT, as volume shown in the account statements was all agency-based. The layoff volume is also relatively small when compared to the overall volume. For example, if BMIS, as a market maker, executes a 700-share customer buy order and then later a 1,000-share customer sell order, the net imbalance would only be 300 shares long. Typically, a market maker like BMIS would attempt to sell off the 300-share position at the end of the trading day without having to carry the open position overnight. For a NASDAQ-listed issue, BMIS would have sold the 300 shares to other market makers. On the other hand, for a NYSE-listed issue, while it is still possible that BMIS could have sold the position to another NASDAQ market maker, due to the fact that the NYSE floor had most of the liquidity, it is more likely that BMIS would have liquidated the position using a NYSE order-routing system via a "sponsored" NYSE member firm (as a non-member firm of the NYSE, in order to access the NYSE floor, BMIS would have to route the order flow through a NYSE member firm).

³⁶ Member firms' principal volume is not reportable to OATS, as OATS only requires the reporting of member firms' customer order flow information. However, if an order is routed from one member firm's principal account to another member firm for execution, then both firms are required to report that order and its status to OATS, as that order is no longer considered "proprietary" once routed.

The following table summarizes the results based on the reported volume to NASDAQ ACT and OATS system as well as the recorded volume in Kingate's account statements.³⁷

Table 1: Selected Stocks from Kingate's Account Statements, March 10 – March 15, 2005

Listing Venue	Stock Ticker Symbol	Total Volume Reported for Kingate by BMIS	Total Volume Reported to ACT by BMIS	Total Volume Reported to OATS by BMIS
NASDAQ	Amgen	1,370,000	247,000	322,000
NASDAQ	Cisco	7,060,000	1,717,000	1,984,000
NASDAQ	Dell	2,646,000	886,000	703,000
NASDAQ	Intel	6,824,000	1,589,000	1,488,000
NASDAQ	Microsoft	11,691,000	2,744,000	2,177,000
NASDAQ	Oracle	5,487,000	1,120,000	799,000
NYSE	Bank of America	4,353,000	1,481,000	N/A
NYSE	Citigroup	5,577,000	1,538,000	N/A
NYSE	Exxon Mobil	6,946,000	2,190,000	N/A
NYSE	General Electric	11,373,000	1,961,000	N/A
NYSE	Hewlett Packard	3,229,000	1,357,000	N/A
NYSE	Pfizer	8,120,000	3,305,000	N/A
NYSE	Time Warner	4,932,000	1,353,000	N/A
NYSE	Wal-Mart	4,598,000	1,012,000	N/A
Note: Kingate volume includes the aggregate transaction volume for Kingate Global Fund and European Fund.				
Volume reported to NASDAQ ACT includes BMIS' tape records as well as clearing records.				
OATS does not include market makers' proprietary volume; OATS is only required for NASDAQ-listed stocks.				

The FTI Engagement Team's analysis shows that, for that one feeder fund alone (Kingate), purported trading volume in selected securities shown on BMIS statements significantly exceeds actual trading volume by BMIS in those securities, according to NASDAQ ACT data (as well as OATS data) provided by FINRA.³⁸ In fact, Kingate's volume surpassed the ACT and OATS volume for every single stock on every single trading day which the FTI Engagement Team

³⁷ For the analysis of the OATS data, in addition to customer order execution volume reported by BMIS, the FTI Engagement Team also analyzed all BMIS customer orders routed to ECNs for execution (e.g., Instinet, BRUT, B*Trade and TRAC, etc.). While ECNs are registered member firms of FINRA/NASD, in effect, ECNs are simply computerized trading systems that facilitate trading by ECNs' own customers, which include market makers, order-entry brokers, institutional traders, day traders and other professional traders. Nevertheless, once an order is routed to an ECN from BMIS, instead of BMIS, the ECN assumes the responsibility to report the order status to OATS as a member firm of FINRA. For our purpose, however, the executed trade should still be credited to BMIS since it involves a customer order from BMIS.

³⁸ There are some volume discrepancies between ACT and OATS databases, mainly due to the differences in reporting requirements by FINRA and NASDAQ. However, the differences in volume are trivial when compared to the differences in volume between those two databases and Kingate's account statements.

has investigated, by a factor ranging from two to as much as 12.³⁹ In contrast, under normal circumstances, account statement volume would be expected to be lower than the reported volume to NASDAQ since the reported volume should also include the BMIS market making volume that was in addition to Madoff's purported trading on behalf of his discretionary accounts.⁴⁰ Moreover, Madoff eventually claimed to have executed trades for "closer to 15" feeder funds; therefore, the discrepancies of volume would have been even more significant had other feeder funds' purported volume been factored into this analysis.⁴¹ The FTI Engagement Team concluded that had the examiners done a similar analysis, the disparity in US trading volume would have been uncovered during their examinations; the only other operating theory at the time to explain that disparity was possible additional trading on the London Stock Exchange and possibly other European exchanges (see Finding 8). With this analysis, then, and with knowledge that the European market for U.S. equities was limited, the examiners would have had a solid indicator to pursue information from European regulators and, in turn, investigate other issues such as custody and existence of client securities.⁴²

Equity Trading – NSCC Database Comparison

The FTI Engagement Team also compared the same trading volume as recorded in Kingate's account statements to the volume cleared and settled by NSCC on behalf of Madoff during the same period in March 2005.

³⁹ For example, on March 14, 2005, Kingate's two fund statements show a total buy and sell trading volume of 1,643,600 shares for Oracle Corporation ("ORCL"), while the reported volume submitted to ACT by BMIS was only about 136,850 shares. Kingate's recorded volume is 12 times as large as the NASDAQ reported volume.

⁴⁰ BMIS was a market maker for the securities listed above, executing trades for other brokers that were separate from any investment advisory accounts; one would expect that some, if not most, of the volume shown in ACT would be attributable to the market-making operations.

⁴¹ Data relating to trades reported by BMIS to NASDAQ ACT or NSCC would be available only to the SEC, FINRA, NASDAQ and DTCC. Absent any specific legal authority, neither the BMIS feeder funds, nor their advisors and auditors, would have had access to the trade execution data needed to prepare an analysis similar to that which the FTI Engagement Team performed for this report.

⁴² Examiners would also have a strong case for following up with European regulators to obtain data on BMIS foreign trades.

Table 2: Kingate's Volume Compared to BMIS' Officially Cleared and Settled Volume, March 10 – March 15, 2005

Stock Ticker Symbol	Total Volume Recorded in Kingate's Accounts	Total Volume Reported to NSCC by BMIS
Amgen	1,370,000	371,000
Cisco	7,060,000	2,342,000
Dell	2,646,000	1,010,000
Intel	6,824,000	N/A
Microsoft	11,691,000	2,963,000
Oracle	5,487,000	1,071,000
Bank of America	4,353,000	1,987,000
Citigroup	5,577,000	2,112,000
Exxon Mobil	6,946,000	3,346,000
General Electric	11,373,000	2,792,000
Hewlett Packard	3,229,000	2,069,000
Pfizer	8,120,000	4,109,000
Time Warner	4,932,000	1,904,000
Wal-Mart	4,598,000	1,366,000

Note: Selected Stocks from Kingate's Account Statements.

Similar to the results above, purported trading volume for the Kingate funds significantly exceeded actual trading volume by BMIS in those securities, as cleared by NSCC. Likewise, had the FTI Engagement Team included other feeder funds' purported trading volume, as well as deducted Madoff's actual market making volume from the NSCC cleared volume, the divergence of volume would be even more obvious and substantial.

Equity Positions – DTC Database Comparison

Finally, the FTI Engagement Team also compared BMIS' securities position holdings as reported by DTC to the overnight equity position of Fairfield, based on a sample of trade confirmations issued by BMIS to Fairfield in January 2005. Based on the FTI Engagement Team's research, BMIS did not hold billions of dollars of S&P 100 equities for Fairfield, as listed on the account statements. For example, as the chart below illustrates, on January 26, 2005, DTC records showed that the BMIS account held a total of 90,200 shares of the above-

mentioned 14 S&P 100 equities in the DTC account.⁴³ On the contrary, the trade confirmation statements produced by BMIS for Fairfield show total holdings of 35,682,300 shares for those same 14 stocks as of January 26, 2005, which exceeded the shares recorded in DTC by a factor of almost 400.⁴⁴ This finding would likely have led SEC examiners to make further inquiries into positions held with any foreign custodians, such as Barclays.⁴⁵

Table 3: Feeder Fund's Equity Positions Compared to BMIS' DTC Positions, Selected S&P 100 Stocks – January 26, 2005

Stock	Fairfield Sentry's Total Position	BMIS' Position as Reported by DTC
Amgen	518,434	1,031
Cisco	2,680,575	16,983
Dell	999,837	1,757
Intel	2,592,170	2,459
Microsoft	4,421,032	11,113
Oracle	2,073,736	2,284
Bank of America	1,643,707	38
Citigroup	2,110,767	8,991
Exxon Mobil	6,430,186	1,559
General Electric	4,309,939	13,386
Hewlett Packard	1,222,023	3,062
Pfizer	3,073,573	8,008
Time Warner	1,865,893	84
Wal-Mart	1,740,457	19,453
Total	35,682,329	90,208

Note: Selected stocks from two Fairfield Sentry accounts' trade confirmations produced by BMIS.
The Depository Trust Company (DTC) makes changes to ownership of the securities on a daily basis.

⁴³ Most of the shares held by BMIS at DTC were likely related to BMIS market-making positions only. The FTI Engagement Team concluded that the DTC records would have included additional shares held by BMIS for its investors had Madoff conducted genuine trades in U.S. markets for those investors because BMIS was acting as their custodian.

⁴⁴ The trade confirmations only provide the asset positions for Fairfield as of the month end date of January 31, 2005. The FTI Engagement Team netted out the trading activities between January 26 and January 31 to arrive at the asset positions as of January 26, 2005.

⁴⁵ OCIE's IA/IC intranet currently includes an examination module titled "Account Statements Sent By Third Party" dated July 2008, which addresses issues associated with reconciling account statements sent by investment advisers with statements sent to customers from outside custodians, although it notes "If client does not receive an account statement from an independent third party, then they would not be able to detect problems or errors or fraud in their account."

After Hour Trading

Both the FINRA/NASD data and DTC/NSCC data would omit any trading in European markets. During the 2005 NERO Cause Examination, according to the OIG's Report of Investigation, Madoff told the SEC onsite examiners that BMIS executed trades for institutional clients in Europe before the 9:30 opening of the U.S. equity markets. In order to verify BMIS' trades on European markets, the OCIE examiners would likely have had to make follow-up requests to European entities and perform additional analyses to draw definitive conclusions as to the existence of fictitious trades or a Ponzi scheme.

Nevertheless, ordinarily only a small percentage of volume for S&P 100 stocks was traded during after hours in Europe before the U.S. markets were open. After-hour markets for US stocks traded in both U.S. and Europe were viewed as illiquid.⁴⁶ Additionally, even though a regular trading day on NASDAQ starts at 9:30 am in the morning and ends at 4:00 pm in the afternoon, a market maker, such as BMIS, could continue to trade after hours on NASDAQ using NASDAQ trading systems or other proprietary trading systems and report trades to the ACT database. In fact, the NASDAQ ACT system accepted trade reporting from 8:00 am in the morning until 6:30 pm in the afternoon during the early 2000s. Furthermore, even with the time differential, the normal trading session for the London Stock Exchange ("LSE"), for example, only ran from 4:00 am EST through 11:30 am EST, which only added an extra four hours from 4:00 am through 8:00 am before NASDAQ ACT and other proprietary trading systems opened. It was not likely that BMIS would transact several hundred thousand shares of volume for each individual stock on each day, as it purported to do for its investment adviser accounts, between 4:00 am and 8:00 am on a European exchange when the market for this time period is viewed by the industry as illiquid.⁴⁷

⁴⁶ See "After-Hours Trading: Understanding the Risks"
<http://www.sec.gov/investor/pubs/afterhours.htm>.

⁴⁷ The same conclusion applies to trading of OEX options during after hours.

Table 4: Kingate Funds Advised by Madoff – Selected Stocks, March 10 – March 15, 2005

Trade Date	Settlement Date	Stock Ticker Symbol	Kingate's Fund Statements Produced by Madoff									Total Volume Reported to FINRA and NASDAQ	Total Volume Reported to NSCC
			Global Fund			European Fund			Grand Total for Kingate				
			Buy Volume	Sell Volume	Total	Buy Volume	Sell Volume	Total					
03/10/05	03/15/05	Amgen	116,276	116,276	232,552	34,388	34,388	68,776	301,328	49,564	69,419		
		Cisco	599,307	599,307	1,198,614	177,242	177,242	354,484	1,553,098	512,697	808,349		
		Dell	226,484	226,484	452,968	66,320	66,320	132,640	585,608	198,030	218,530		
		Intel	579,295	579,295	1,158,590	171,324	171,324	342,648	1,501,238	376,369	576,369		
		Microsoft	992,487	992,487	1,984,974	293,524	293,524	587,048	2,572,022	640,072	660,608		
		Oracle	465,843	465,843	931,686	137,771	137,771	275,542	1,207,228	165,072	176,739		
		Bank of America	369,579	369,579	739,158	109,301	109,301	218,602	957,760	293,939	436,129		
		Citigroup	473,410	473,410	946,820	140,009	140,009	280,018	1,226,838	317,882	443,570		
		Exxon Mobil	589,521	589,521	1,179,042	174,397	174,397	348,794	1,527,836	928,764	1,459,494		
		General Electric	965,485	965,485	1,930,970	285,538	285,538	571,076	2,502,046	447,197	650,168		
		Hewlett Packard	274,079	274,079	548,158	81,057	81,057	162,114	710,272	294,566	430,235		
		Pfizer	689,351	689,351	1,378,702	203,872	203,872	407,744	1,786,446	808,872	1,089,194		
		Time Warner	418,672	418,672	837,344	123,820	123,820	247,640	1,084,984	284,003	387,831		
		Wal-Mart	390,355	390,355	780,710	115,446	115,446	230,892	1,011,602	308,760	414,497		
03/11/05	03/16/05	Amgen	148,410	148,410	296,820	43,891	43,891	87,782	384,602	85,866	118,626		
		Cisco	764,933	764,933	1,529,866	226,226	226,226	452,452	1,982,318	425,108	532,430		
		Dell	286,220	286,220	572,440	84,648	84,648	169,296	741,736	205,089	238,270		
		Intel	739,392	739,392	1,478,784	218,672	218,672	437,344	1,916,128	486,664	629,608		
		Microsoft	1,266,774	1,266,774	2,533,548	374,643	374,643	749,286	3,282,834	593,384	793,608		
		Oracle	594,586	594,586	1,189,172	175,846	175,846	351,692	1,540,864	475,126	476,304		
		Bank of America	471,717	471,717	943,434	139,508	139,508	279,016	1,222,450	483,838	582,600		
		Citigroup	604,243	604,243	1,208,486	178,702	178,702	357,404	1,565,890	454,555	642,929		
		Exxon Mobil	752,654	752,654	1,505,308	222,594	222,594	445,188	1,950,496	417,045	616,903		
		General Electric	1,232,310	1,232,310	2,464,620	364,451	364,451	728,902	3,193,522	475,714	651,374		
		Hewlett Packard	349,825	349,825	699,650	103,459	103,459	206,918	906,568	654,482	983,184		
		Pfizer	879,863	879,863	1,759,726	260,216	260,216	520,432	2,280,158	1,082,692	1,179,403		
		Time Warner	534,378	534,378	1,068,756	158,040	158,040	316,080	1,384,836	270,158	379,136		
		Wal-Mart	498,236	498,236	996,472	147,351	147,351	294,702	1,291,174	251,665	320,167		
03/14/05	03/17/05	Amgen	158,305	158,305	316,610	46,818	46,818	93,636	410,246	48,362	74,665		
		Cisco	815,929	815,929	1,631,858	241,308	241,308	482,616	2,114,474	399,100	482,566		
		Dell	305,302	305,302	610,604	90,292	90,292	180,584	791,188	256,246	280,219		
		Intel	788,685	788,685	1,577,370	233,373	233,373	466,746	2,044,116	466,927	633,666		
		Microsoft	1,351,226	1,351,226	2,702,452	399,619	399,619	799,238	3,501,690	855,464	935,107		
		Oracle	634,225	634,225	1,268,450	187,570	187,570	375,140	1,643,590	136,949	152,849		

Kingate's Fund Statement: Produced by Madoff											
Trade Date	Settlement Date	Stock Ticker Symbol	Global Fund			European Fund			Grand Total for Kingate	Total Volume Reported to FINRA and NASDAQ	Total Volume Reported to NSCC
			Buy Volume	Sell Volume	Total	Buy Volume	Sell Volume	Total			
		Bank of America	503,165	503,165	1,006,330	148,809	148,809	297,618	1,303,948	382,839	511,549
		Citigroup	644,526	644,526	1,289,052	190,678	190,678	381,357	1,670,409	319,864	428,764
		Exxon Mobil	802,831	802,831	1,605,662	237,434	237,434	474,868	2,080,530	388,973	551,629
		General Electric	1,314,465	1,314,465	2,628,930	388,747	388,747	777,494	3,406,424	512,919	749,432
		Hewlett Packard	373,147	373,147	746,294	110,357	110,357	220,714	967,008	246,255	411,685
		Pfizer	938,521	938,521	1,877,042	277,564	277,564	555,128	2,432,170	763,924	1,017,652
		Time Warner	570,004	570,004	1,140,008	168,576	168,576	337,152	1,477,160	329,007	445,808
		Wal-Mart	531,451	531,451	1,062,902	157,174	157,174	314,348	1,377,250	239,554	340,710
03/15/05	03/18/05	Amgen	105,537	105,537	211,074	31,213	31,213	62,426	273,500	63,460	107,990
		Cisco	543,954	543,954	1,087,908	160,872	160,872	321,744	1,409,652	379,657	518,881
		Dell	203,536	203,536	407,072	60,195	60,195	120,390	527,462	226,937	272,487
		Intel	525,790	525,790	1,051,580	155,501	155,501	311,002	1,362,582	259,151	337,666
		Microsoft	900,818	900,818	1,801,636	266,414	266,414	532,828	2,334,464	655,010	737,366
		Oracle	422,818	422,818	845,636	125,047	125,047	250,094	1,095,730	343,069	465,065
		Bank of America	335,444	335,444	670,888	99,207	99,207	198,414	869,302	320,620	456,620
		Citigroup	429,685	429,685	859,370	127,078	127,078	254,156	1,113,526	445,596	596,295
		Exxon Mobil	535,221	535,221	1,070,442	158,290	158,290	316,580	1,387,022	455,498	717,686
		General Electric	876,311	876,311	1,752,622	259,166	259,166	518,332	2,270,954	525,258	740,685
		Hewlett Packard	248,765	248,765	497,530	73,572	73,572	147,144	644,674	161,333	244,346
		Pfizer	625,681	625,681	1,251,362	185,043	185,043	370,086	1,621,448	649,832	823,055
		Time Warner	380,003	380,003	760,006	112,385	112,385	224,770	984,776	470,234	691,202
		Wal-Mart	354,302	354,302	708,604	104,784	104,784	209,568	918,172	212,014	290,529

Note: No data capturing potential Madoff's trading executed through the New York Stock Exchange ("NYSE") system for NYSE-listed stocks is available. Total Volume reported to NASDAQ ACT system includes Madoff's clearing records, in addition to tape records.

Table 5: Madoff's Trading Volume from OATS, Six Stocks: Microsoft, Intel, Dell, Oracle, Amgen and Cisco, March 10 – March 15, 2005

Trade Date	Settlement Date	Stock Ticker Symbol	Volume Reported by Madoff Directly	Volume Reported by Trading Systems for Madoff	Total Volume Reported to OATS
03/10/05	03/15/05	Amgen	37,807	18,647	56,454
		Cisco	401,097	302,652	703,749
		Dell	123,820	19,300	143,120
		Intel	262,200	122,874	385,074
		Microsoft	441,835	36,363	478,198
		Oracle	111,405	14,067	125,472
03/11/05	03/16/05	Amgen	69,230	31,193	100,423
		Cisco	328,383	121,172	449,555
		Dell	144,451	26,890	171,341
		Intel	360,080	187,958	548,038
		Microsoft	411,818	47,538	459,356
		Oracle	276,129	56,378	332,507
03/14/05	03/17/05	Amgen	44,188	24,259	68,447
		Cisco	292,335	111,090	403,425
		Dell	165,306	29,198	194,504
		Intel	249,524	103,345	352,869
		Microsoft	562,763	140,891	703,654
		Oracle	107,549	18,300	125,849
03/15/05	03/18/05	Amgen	56,291	40,476	96,767
		Cisco	262,905	163,909	426,814
		Dell	153,017	41,075	194,092
		Intel	156,499	45,994	202,493
		Microsoft	445,370	90,432	535,802
		Oracle	188,444	26,900	215,344

Note: OATS does not include market makers' principal volume.

Audit Requests and Ideas

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