

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

In the Matter of:)
) File No. OIG-509
OIG-509)

 ORIGINAL

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 Securities and Exchange Commission
 100 F Street, N.E.
 Washington, D.C. 20549
DATE: Monday, March 23, 2009

The above-entitled matter came on for hearing, pursuant to notice, at 2:06 p.m.

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1 APPEARANCES:

2

3 On behalf of the Securities and Exchange Commission:

4 H. DAVID KOTZ, Inspector General

5 HEIDI STEIBER, Investigator

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9 Washington, D.C. 20549

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11 On behalf of the Witness:

12 MATTHEW DAUGHERTY, PRO SE

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C O N T E N T S

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2			
3	WITNESS		EXAMINATION
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5			
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8		5/29/03	25
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MR. KOTZ: Okay, we are on the record at 2:06 on March 23, 2009, at the United States Securities and Exchange Commission Office of Inspector General. I'm going to swear you in.

MR. DAUGHERTY: Okay.

MR. KOTZ: Could you please raise your right hand? Whereupon,

MATTHEW DAUGHERTY

was called as a witness and, having been first duly sworn, was examined and testified as follows:

EXAMINATION

BY MR. KOTZ:

Q Could you state and spell your full name for the record?

A Matthew, M-a-t-t-h-e-w, no middle initial, Daugherty, D-a-u-g-h-e-r-t-y.

Q Okay. Mr. Daugherty, my name is David Kotz, and I'm the Inspector General of the United States Securities and Exchange Commission. This is an investigation by the Office of Inspector General, case number OIG-509. With me today, I have my colleagues from the Office of Inspector General, Heidi Steiber and Chris Wilson.

I'm going to ask you certain questions and you'll provide answers under oath. The court reporter will record

1 oversight examination looking for issues that you might, sort
2 of, risk focus while you're there, depending on what you see
3 when you're examining that registrant.

4 Whereas in the cause context, you have an idea of
5 something that may be occurring, and you're going in to look
6 for that specific thing. So you got a tip from somebody or,
7 you know, you read a newspaper article in the Wall Street
8 Journal, or you would go look for something on a cause basis
9 by focusing on that specific thing at the registrant.

10 Q So would you say there's a difference in the terms
11 of the urgency for a cause exam versus a routine exam?

12 A There can be. I'd say that the focus is much more
13 specific and granular in a cause exam, but that -- I've been
14 in routine exams that have uncovered significant violations
15 that have been -- we've had to prioritize potentially over
16 other cause exams.

17 So I can't say that, you know, we prioritize cause
18 exams over routine exams. It's more dependent on, sort of,
19 what the status of each exam is at a certain time.

20 Q Mm-hmm. And what would be some of the causes that
21 you would have to have a cause exam, I mean, like what is the
22 cause?

23 A Sure. There could be allegations of trading
24 violations. There could be -- I mean, some of the -- I can
25 give you -- some of the cause exams I've worked on here

1 Q Okay, so -- well, how would you characterize this?
2 Routine examination, inspection, cause examination?

3 A I would characterize this as cause examination.

4 Q So what was the cause? What was it initiated by?

5 A Okay. This is -- again, recalling something that
6 happened --

7 Q Okay.

8 A -- several years ago --

9 Q I got you.

10 A -- but my recollection of this was that at the
11 time the market in -- for the Qs, as they call them, QQQ, was
12 very fragmented and hectic, and that there were potential, I
13 guess, thoughts or concerns. I'm not sure exactly what the
14 genesis of them were, whether it was, sort of, known in the
15 industry, or thought in the industry, or there was a tip in
16 the Wall Street Journal, or whatever.

17 I can't remember exactly, sort of, if there was a
18 tipping point or a specific impetus for looking at this,
19 other than the sort of general concerns that I knew about,
20 that there was potential for illicit trading, if you will, in
21 the triple Qs, particularly during periods where the market
22 in the securities quote unquote locked or crossed.

23 So I believe what we determined to do was to
24 initiate what I guess now would be referred to as a sweep
25 inspection -- I'm not even sure if we used the term back

1 then -- of some market makers and exchanges, to look at their
2 trading in the Qs, and see if we could ascertain whether
3 there may or may not be any, sort of, illicit trading, sort
4 of, best execution trading or trading ahead, or any of those
5 potentialities, so --

6 BY MS. STEIBER:

7 Q Is trading ahead front running, same thing?

8 A Well, generally speaking -- it's used
9 interchangeably somewhat, but I think it's a little bit more
10 nuance, and I think trading ahead is generally considered
11 when -- it can happen on a small share basis, say a hundred
12 shares, where some would -- a specialist or a market maker
13 would trade ahead of an order that they hold -- have a
14 fiduciary duty to hold and execute in a certain manner, and
15 trade at a better price, and then, say for instance, sell
16 back to that order at a -- at another price, which would be,
17 inner-positioning, potentially.

18 Inner-positioning is a variant of trading ahead,
19 where you, sort of, go between two orders that should just
20 have been matched up. You trade for your own account in two
21 instances and, sort of, capture a self-made spread, if you
22 will.

23 Front running is generally used as a method of,
24 say, trading ahead of a block order, something you know is
25 going to move the whole market.

1 You get out in front of it, if you will, and front
2 run its appearance in the market, so that you can trade on
3 the knowledge -- sort of -- actually, when they bring an
4 action, it's usually under those -- from like insider trading
5 laws, I think, so that you can sort of -- you know there's
6 a -- you have material information about something that's
7 going to move the market, and you trade -- you front run it.
8 See, I almost did it too.

9 Q So the trading ahead and front running are
10 different than cherry picking?

11 A I'm not even sure I know what cherry picking is.

12 Q Okay.

13 A It's -- there's probably a euphemism for it as
14 well, but I'm not sure. There's penny jumping, there's all
15 kinds of crazy terms about this type of, like, trading around
16 customer orders, but --

17 Q Okay.

18 BY MR. KOTZ:

19 Q Okay, and so as part of this cause exam, this
20 triple Q exam, you looked at Bernie Madoff Securities, is
21 that right?

22 A Yes. So we sent letters to, I believe -- I have
23 the document in front of me, I just haven't read it in a
24 while -- two market makers and three SROs, to look at trading
25 in the triple Qs. And yes, the intent was to obtain trading

1 data, to review it in order to determine whether we could
2 identify instances in which they failed to properly execute
3 customer orders for -- in sum.

4 Q And who were the market makers you sent it to?
5 There were two of them?

6 A Yes, there was Bernard -- well, it's really called
7 Bernard Madoff Investment Securities and Knight Securities,
8 which were -- in my understanding, were the two biggest, at
9 the time -- biggest market makers at the time.

10 I think Madoff and Knight, particularly enlisted
11 the over the counter listed market, whereas most market
12 making at the time was sort of considered in the NASDAQ stock
13 market, and NASDAQ at the time was not an exchange.

14 They had market makers making up a market, and
15 NASDAQ securities like Microsoft, Intel, all traded, and
16 there was market makers in those stocks. There wasn't -- for
17 listed stocks, stocks listed on an exchange like, obviously
18 an easy one would be like IBM, on the New York Stock
19 Exchange, or some of the ETFs, like the Qs on let's say Amex,
20 there was trading at the exchanges, and there was also
21 trading on what was -- has -- had numerous names.

22 I think at the time it was probably NASDAQ inner
23 market or the third market, which was sort of over the
24 counter trading in listed securities. And I believe Knight
25 and Madoff were big market makers in exchange listed

1 securities over the counter.

2 And we also looked at three exchanges at the time,
3 too, to look at their trading in these securities.

4 Q So you picked Madoff and Knight because they were
5 the two most likely to have potentially committed these
6 violations that you were concerned about?

7 A Yeah. I don't believe that there was any evidence
8 that we had that they were committing violations. It was
9 more we wanted to look at the big players, because we figured
10 that's the best place to start with this type of thing.

11 Q Okay. Who was bigger, do you remember, Knight or
12 Madoff?

13 A I would have no idea.

14 Q And so what was your role on this triple Q cause
15 exam?

16 A Well, I was the, I guess, lead attorney, for the
17 examination when it was begun. If you look at the planning
18 memo, it's from John McCarthy, Eric Swanson, and Matt
19 Daugherty.

20 There's no branch chief named on it, so I guess
21 it's a good example of the situation when we -- when I first
22 started in OC, that there wasn't a lot of bodies, so there
23 was occasions where I would work directly for an assistant or
24 even an associate director on something, because there just
25 was, sort of -- you know, everyone was so busy, and we were

1 just sort of assigning out projects, and --

2 Q So --

3 A -- I'm sorry.

4 Q So in this particular cause exam, you were working
5 directly for Eric Swanson, and then above him to -- for John
6 McCarthy.

7 A That's correct.

8 Q Okay. And so what was your role in that capacity?

9 A My role, I guess, was to perform the role of a lead
10 attorney. I believe ultimately we staffed it -- there's a
11 caveat that I have to introduce here in a minute, but
12 there -- at the time we had staffed it with some staff
13 attorneys to do a review.

14 I could see from the e-mail that you -- that's
15 labeled Exhibit 1 that there was two staff attorneys,
16 Christopher Chase and Shauna Sappington cc'd on it. I
17 believe that they were initially given -- handed out the data
18 that came in to review it.

19 The -- and my role was to sort of lead the
20 inspection and the examinations, so just conduct the day to
21 day activities of examining them, to go on site, to review
22 the documents after the staff had had a chance to evaluate
23 them, that type of thing.

24 If you note the date on here, March 3, 2003, this
25 was probably two months before the Wall Street Journal picked

1 up the story about [Personal Privacy] and trading, and
2 inner-positioning and trading ahead on the New York Stock
3 Exchange.

4 When -- when you talk about prioritizing -- when
5 that hit, I was one of the only people in the office that
6 really had any, sort of, trade devaluation experience because
7 of my time at the NASD, so I was actually taking -- taken off
8 this project and put onto the New York Stock Exchange project
9 as the lead of that inspection, so --

10 Q And when was that?

11 A That was -- I mean, we started that, I believe it
12 was in May 2003. I don't know an exact date. But we sent a
13 doc request for New York Stock Exchange. It had to have been
14 in May of 2003. Well, I don't -- I say, "had," but I don't
15 know.

16 Q But according to Exhibit 1, May 29, you seem to
17 still have been on the --

18 A Yeah, I was -- I was still on this, like, up till
19 about May, and then ultimately I believe Mark Donahue came in
20 my office and said, "You're going to be leading New York
21 Stock Exchange. We're going to have to figure out a way to
22 sort of lighten your load," I believe were his exact words,
23 something to that effect, at least.

24 But there were several projects that I was on at
25 the time. I was looking at trading at the open and -- by

1 Goldman Sach's and a couple other firms related to Intel. I
2 was -- I believe I had been put on a CSE inspection at the
3 time. I was also on an inspection of the International
4 Securities Exchange, or ISE, at the time.

5 There was a lot of projects that I was -- that were
6 sort of taken off my plate, and eventually, in, like, May or
7 June -- obviously there was some sort of transition period --
8 I was taken off this project to work almost exclusively on
9 New York.

10 And whereas our inspections generally last a year
11 or two when you were doing a full SRO inspection, I think we
12 finished that in, like, November of 2003. So it was a six
13 month inspection.

14 So I was basically taken off that, and worked
15 almost exclusively on that six or seven days a week, from say
16 May-ish, June-ish, clearly, until -- until later in that year
17 of --

18 BY MS. STEIBER:

19 Q 2003, or --

20 A -- 2003. I'm sorry.

21 BY MR. KOTZ:

22 Q For how long of a period did you work on the QQQ
23 cause exam?

24 A I can tell you what I did. I don't know that I can
25 tell you the exact dates. I sent the doc request -- I wrote

1 obviously a planning memo, I sent the document request out, I
2 had some conversations with the registrants, including, I
3 believe, Madoff, about obtaining documents.

4 Q Which Madoff was that?

5 A You know, I believe I spoke to Shayna or Shana
6 Madoff.

7 Q Shana Madoff.

8 A Shana Madoff.

9 Q Okay.

10 A I can't tell you when -- about obtaining the data,
11 maybe -- I don't know if it was to get an extension, or if it
12 was about the data.

13 I think at one point, we had actually asked --
14 again, I haven't thought about this in several years, so if
15 it pops back into my head, I'll tell you in the course of our
16 time here, but I think they had sent in -- they were one of
17 the firms, or maybe one of the only firms that sent the
18 information in in paper, so I think we had talked to them
19 about getting it electronically, but again --

20 BY MS. STEIBER:

21 Q Was that unusual to get a submission like that in
22 paper?

23 A You know, not in 2003. I mean, I had just finished
24 up -- when I first started, we had finished up doing e-mail
25 reviews of all the rating agency -- research analyst conflict

1 issues with Personal Privacy and all that stuff, and I think
2 every -- I looked at 25 boxes of e-mails and it was all
3 paper.

4 So at the time it -- some people had the ability to
5 put stuff in electronic format, and some didn't. So I
6 wouldn't say at that time it was unusual that it was only
7 paper, and I'm not even sure we didn't get it electronically.
8 So it wasn't like shocking that I got it that way.

9 But obviously now it would be a little different,
10 than again, only six years -- five or six years ago.

11 BY MR. KOTZ:

12 Q And so did somebody take over for you when you were
13 pulled off this QQQ cause exam involving Madoff to go on the
14 New York Stock Exchange matter?

15 A Yes. So my recollection at the time was that I
16 wasn't the only busy one in the office, that so were the
17 staff attorneys, and Chris Chase and Shauna both started, I
18 think, in April of 2003. And they got put on initially, and
19 sort of had this on their plate.

20 But I'm not sure that they, were even the staffers
21 that continued on this project. I think they got staffed up
22 on other things. Again, we were always sort of
23 reprioritizing at the time.

24 We were -- literally were swamped. Not that we
25 aren't now, but my recollection is that -- at least for -- so

1 there's three SROs -- I believe for Chix, a staff person
2 named Tom Stickley, who was a former market maker at Deutsche
3 Bank, or a trader at Deutsche Bank, started working at least
4 on Chicago Stock Exchange, if not on more than them, and had
5 done some work, and identified some potential trades by the
6 specialist, where I believe he might have been trading ahead.

7 Maybe ^{OCIE Staff Attorney} [REDACTED] might be somebody that had worked
8 on some of this stuff --

9 Q Mm-hmm.

10 A -- but I don't think that another -- I don't think
11 anyone else coordinated it as I was going to coordinate it
12 with all of them. I think maybe Eric kept it, and
13 coordinated them individually.

14 One sort of intervening issue in some of this was
15 that we had a very, sort of, unevolved, for lack of a better
16 term, thought about what might be happening on the exchanges
17 with respect to the Qs.

18 What we ultimately learned from the New York Stock
19 Exchange inspection and attendant regional inspections that
20 we started, more broadly than just the Qs, was that there
21 was, sort of, rampant trading ahead on every exchange at the
22 time.

23 And that's why, I think there was a bunch of
24 enforcement actions just announced -- bunch of options market
25 makers and some other things -- we ended up starting

1 inspections on every exchange.

2 So we initially -- and so instead of just looking
3 at the Qs, we looked at every security, and instead of just
4 looking at these three, and a couple market makers, we looked
5 at the NASDAQ, we looked at all other regional exchanges. We
6 obviously looked at the New York Stock Exchange.

7 So this was sort of a start to what probably you
8 could say ended up being coalescing in a much larger
9 initiative that involved several market makers and
10 specialists -- several dozen market makers and specialists,
11 on both equities and options markets, as well as a bunch of
12 NRS -- or SRO inspections, which led to enforcement actions.

13 Q All right. But what happened with this particular
14 cause exam that related to Bernie Madoff?

15 A I don't know.

16 Q Okay. Well, what do you know was done with respect
17 to this QQQ cause exam of Bernie Madoff? Did you receive
18 documents back --

19 A I'm sorry. I didn't mean to stop you. I believe,
20 again, that I received documents, spoke with Shana Madoff
21 either prior to receiving those documents about something
22 else, or following receiving those documents about whether --
23 that we could get them electronically.

24 Because if I recall, they might have been produced
25 on sort of like a green and white dot matrix-y type thing. I

1 can't really remember. And -- but we wanted to be able to
2 sort it, and analyze it electronically, obviously.

3 And then after that, I remember being effectively,
4 in large part, again, taken off of this project. When I say,
5 "in large part," I mean, I might have been involved in some
6 e-mailing or dispersing the data to various people, or giving
7 up my case files, which I clearly would have done.

8 You know, I'd received, either directly, or through
9 Eric, a lot of the e-mail submissions of trading data from
10 the SROs and the BDs, and then, sort of, passes out -- would
11 have passed it out to people including Tom Stickley, who was
12 one of the people along with, you know, Shauna and Chris,
13 that might have been working on it.

14 But as far as I knew, I had no more involvement
15 with it after some point, and I'm not sure what would -- how
16 this examination would have ended or not.

17 Q Okay. Do you know if they were ever -- anybody was
18 ever on site from the SEC at Madoff?

19 A I do not know.

20 Q You were never on site at Madoff's in connection
21 with this?

22 A No, I was not.

23 Q Okay. Okay. Let me show you another document.
24 And that we're going to mark as Exhibit 2.

25 A Okay.

1 (SEC Exhibit No. 2 was marked for
2 identification.)

3 BY MR. KOTZ:

4 Q This is an e-mail from [REDACTED], dated
5 Wednesday, May 21, 2003, 5:47 p.m. to Mavis Kelly, and it is
6 a two-page document with several attachments. So if you
7 could take a look at this, please.

8 A Okay.

9 Q Okay?

10 A How detailed do I need to look at this?

11 Q You can just look at the first two pages first, if
12 you want, and then I'll ask you questions.

13 A Okay.

14 Q Okay. Have you ever seen this document before?

15 A I don't believe so.

16 Q Okay. Tell me generally, first. How does OC
17 handle tips or complaints? Are there formal policies or
18 procedures?

19 A There are now. I would say there were not --
20 previously to -- there clearly were not during the period
21 where -- in 2003 when this e-mail was dated.

22 Q So how were things handled during that period, May
23 2003?

24 A It's going to sound Clinton-esque, but I guess it
25 depends what your definition of complaint is. I mean, we

1 get, like, there was multiple ways a cause inspection could
2 have started. It could have been a complaint, if you will,
3 in a newspaper article, or it could have been somebody
4 literally calling up and saying, you know, anonymously,
5 something's going on, or somebody sends an e-mail to the
6 Commission's in box, or whatever.

7 Sometimes now I'll get complaints. I'm sure John
8 and Eric got complaints. I'm sure Lori gets complaints. I'm
9 sure we read about complaints.

10 So we didn't have any standardized method of
11 handling these. It just usually -- obviously -- you know, if
12 I got something, I would have passed it up to my superiors,
13 but I'm not sure ultimately how they were handled.

14 Q Would they have been logged into some kind of
15 database or a spreadsheet?

16 A No.

17 Q Okay. So if you got a tip or a complaint, who
18 would you give it to? What would you do with it?

19 A Well, A, now we have a log, but B, it would
20 depend --

21 Q At this time period.

22 A -- yeah, at this time period, and B, it would
23 depend what it was about, and who it was for. If it was
24 related to an SRO or somebody that we actually did the
25 inspections and examinations of, I would probably tell

1 Bernie Madoff?

2 A All right. Well, the answer's going to be
3 different based on my recollection, versus based on the
4 document. My recollection -- I don't really have a
5 recollection as to what happened, without looking at what the
6 document says, and I'll literally have to read it verbatim as
7 to what it says, to tell you what happened.

8 But as the memo indicates, it seems like finally
9 I'm off -- I'm out of the loop. I'm not on the memo, so
10 finally they figured that I was too busy working on other
11 things to actually pay attention to what they were sending
12 me.

13 So I mean, sort of, skimming through it, it looks
14 like they had -- potentially have some issues with execution
15 quality, and some gains, and from -- trading gains, I don't
16 know that -- whether they're means that's illicit, or illicit
17 trading gains, but that it says obviously, the first line on
18 the conclusion section, section five on page -- what appears
19 to be page 3, says that "based on the activity outlined in
20 this memo, the staff believes that there is a best execution
21 problem with Madoff."

22 Q Okay. And so this is dated November 10, 2003.

23 A Mm-hmm.

24 Q And so is it fair to say that this triple Q
25 examination went on from March 2003 to November 2003?

1 maybe Gen Walker.

2 Q Okay.

3 A And then I don't -- it doesn't appear that there
4 was a branch chief on it, or that I can recall.

5 Q Did you have any involvement in this cause exam?

6 A My involvement in this cause exam I think was
7 related to some research or maybe a memo I drafted on whether
8 his investment advisory business should be registered with
9 the Commission. It was several years ago, and I know we
10 pulled a bunch of documents in relation to your
11 investigation, but I didn't really read over stuff too much.

12 But I think Mark had asked me to do some research
13 for him, particularly since I was kind of interested in that
14 area, since at the time, I think the Commission was
15 considering whether to have hedge funds register, so I had
16 kind of been -- kind of just doing a little research in that
17 area for my own edification, and just Mark had asked me to
18 give him some -- a memo on it.

19 Again, that's my recollection at this time.

20 Q Do you know how you initially heard that they were
21 doing this cause exam of Madoff?

22 A I don't know that I can say that, based on this
23 e-mail, whether I even knew it was Madoff that they were
24 examining, at the time I sent these letters. It basically
25 just says I -- and again, I'm not trying to be cute about it,

1 Q Right. So I mean, would it be fairly unusual for
2 Lori herself to have a conversation with an individual as
3 part of a cause exam?

4 A No. I know Lori has -- for better or for worse,
5 for everyone's sake, I've worked on a lot of high profile
6 inspections and exams here, and Lori's been involved in
7 conversations with the registrants, particularly the heads of
8 registrants, on multiple occasions that I've been a part to.

9 Q Okay.

10 A So that's not an unusual thing.

11 Q Do you remember in the -- this particular cause
12 exam, whether Lori had a particular theory, or expressed an
13 opinion about whether the things you were looking at were
14 accurate, based on her conversation with Madoff or otherwise?

15 A No, I don't know that it would be any different
16 than, sort of, the genesis of the examination itself, which
17 again, I'm not sure who started this exam, but I presume it
18 was Lori, John, or Eric, or Mark, so -- but I don't know what
19 the genesis of it was.

20 And if she started it, I would assume it's the same
21 as what her thoughts about it were for starting it, but
22 whether they changed based on this conversation, I just -- I
23 don't know.

24 Q What was your understanding as to the focus of this
25 particular cause exam that's referenced in this December 2003

1 fine job.

2 Q But I mean in terms of -- in the time period of
3 December 2003, is it fair to say that Jackie Wood was pretty
4 junior, relatively inexperienced?

5 A Pretty junior, but not relatively inexperienced --

6 Q Okay.

7 A -- because we didn't have many experienced people
8 at all.

9 Q Okay. Okay. So not inexperienced relative to the
10 other people --

11 A Yes.

12 Q -- but relatively inexperienced in a broader
13 sense, would you say?

14 A It depends what your baseline is. I don't know.
15 We -- and like I said, we were expanding rapidly and had a
16 lot of inexperienced people at the time.

17 Q So was Jackie Wood one of those inexperienced
18 people you had at the time?

19 A Jackie Wood was, but at the same time, I had only
20 been here, what, a year too, and I was leading up a bunch of
21 exams too, so I guess you could say we were all effectively
22 inexperienced.

23 Q Okay. What about Genevievette Walker, what was
24 your impression of her expertise?

25 A Gen was here before and -- I'm sorry. Gen was in

1 advantage of that.

2 It should likely be in equities, because I think
3 that's what he traded in the market maker side. It wasn't
4 like an options market maker, or anything like that. I think
5 that's what he traded.

6 So if you were looking specifically for that, yes,
7 you could go to -- well, it depends what stocks you thought
8 he was disadvantaging. Because if it was New York listed
9 stocks, you would go to New York. If it was third market
10 stocks like the Qs, or NASDAQ listed stocks like Microsoft,
11 you would go to the NASD, or FINRA, or whatever they're
12 called now.

13 If you thought it was an options issue, which
14 again, now I see this deals with options, then I don't know
15 that they were dealing a lot with that, but if they had
16 looked at his trading and the trading in the market maker,
17 which we know now, or might have known then too, dealt with a
18 lot of options trading in the, I guess, the S&P 100, and some
19 other stuff, then you wouldn't necessarily go to the NASD for
20 that, because they wouldn't have it.

21 Q Where would you go for that?

22 A Well, I guess if you wanted options information,
23 you would go to -- again, I'm not a -- I know a lot less
24 about the option market than I do about fixed income or
25 equities or rating agencies.

1 go and try to pick a market where you think the data -- the
2 trading might be taking place, and try to get their data, but
3 again, they're not going to have the same data as, like, New
4 York Stock Exchange would, or whatever. But going to an
5 exchange to get trading data in a trading case clearly isn't
6 an unusual activity.

7 Q Okay. So normally, given the type of allegations
8 that they were looking at in this cause exam --

9 A Mm-hmm.

10 Q -- that Genevieve Walker and Jackie Wood worked
11 on, you wouldn't have gone to the NASD to get trading data?

12 A Now, I don't know that I -- are you talking
13 specifically about the items that they were examining that
14 are reflected in his e-mail to me?

15 Q Well, you had some understanding of what Jackie
16 Wood and Genevieve Walker and Mark Donahue were looking at
17 in connection with the 2004 cause exam of Madoff. In
18 connection with that activity --

19 A Right.

20 Q -- in a normal situation like that, would you have
21 gone to the NASD to get any trading data?

22 A I'm trying not to conflate too many things, because
23 there were allegations that he might have been trading
24 initially -- there were some allegations that he might have
25 been trading in his -- through his market maker, taking

1 days with critical get OATS from NASD and ACT all Madoff
2 orders."

3 A Uh-huh.

4 Q Do you know what that would refer to, "get OATS
5 from NASD"?

6 A OATS is a Order Audit Trail System, so it shows you
7 the orders -- information about the orders that are
8 submitted. And ACT is something, something, something,
9 Automated -- I can't remember, but it shows you the execution
10 data. I can't remember what it stands for.

11 Q And why would you get OATS from NASD and ACT from
12 Madoff?

13 A One reason would be to review the order entry
14 information and the execution information from -- that the
15 NASD has stored regarding certain trades.

16 Q Do you know if anybody ever did get the OATS from
17 NASD and ACT from Madoff?

18 A I do not know.

19 Q Is that a difficult thing to do, to get that OATS
20 data from NASD?

21 A It depends how much you want. Obviously in a
22 highly liquid securities there's, like, millions -- well, a
23 lot of orders, so sometimes getting the information, getting
24 a lot of information can take some time, or cause some
25 consternation.

1 But generally speaking, if you wanted to look at a
2 limited sample of orders, it shouldn't even be a problem at
3 all. And even if it's a lot, we can always get it, but --
4 could I go out and say, "Give me the OATS data for the market
5 for the last year," to NASD, I don't think they literally
6 could produce that to me.

7 But if I wanted some reasonable data set from them
8 of OATS and ACT data, it shouldn't be a problem at all.

9 Q Okay. If you look on the last page, first of all,
10 "black box" at the bottom.

11 A Uh-huh.

12 Q Did you ever that of that phrase in connection with
13 Madoff Securities?

14 A I've heard of that phrase in connection with a lot
15 of algorithmic and market making firms.

16 Q Okay. But do you remember particularly with regard
17 to this cause exam, any talk about a black box that Madoff
18 was using?

19 A Yeah. Mark likes the term. I think it was
20 probably used in my conversations with him, but more along
21 the lines of -- I mean, I remember -- I recall having a
22 conversation with Mark about the exam to the extent of what
23 Madoff -- how Madoff was trading and making money in his
24 fund, whether he was making money from a strategy --

25 Q Mm-hmm.

1 from an examination context.

2 So my guess would be, and my slight recollection
3 from talking about this, is that he -- it was never resolved
4 for him, and couldn't be resolved under our authority in OC.

5 BY MS. STEIBER:

6 Q Well, I'm confused by what you're saying, because
7 you had one registered entity --

8 A Uh-huh.

9 Q -- and there is no other entity.

10 A Uh-huh.

11 Q And the trading is occurring in brokerage accounts.
12 What record would you not be able to get from Madoff
13 Securities?

14 A Again, I'm no expert on the advisor's act, but
15 it --

16 Q But you don't have a -- he's not claiming to be an
17 advisor. You have one registered entity, you have all the
18 trading occurring in brokerage accounts.

19 A I'm sorry. My recollection was that he had been
20 claiming to be an investment advisor. I mean, Madoff ran an
21 advisory service that was the Ponzi scheme, right?

22 Q If you had -- what I'm just saying is just take it
23 for what I say.

24 A Okay.

25 Q You have one registered entity --

1 A Okay.

2 Q -- not claiming to be an investment advisor.

3 A That would be the broker-dealer, correct?

4 Q So you have a broker-dealer --

5 A Okay.

6 Q -- not claiming to be an investment advisor.

7 A Absolutely true.

8 Q All the trading is occurring in brokerage accounts.

9 A Uh-huh.

10 Q Is there any record that you couldn't get from that
11 broker-dealer?

12 A No, we could get anything from that broker-dealer.

13 Q Okay.

14 A Yeah. But I think the -- I'm sorry. My point
15 about the black box was that I don't know that we could get
16 information about his hedge fund trading or strategies or
17 whatever. And I think the black box dealt with the hedge
18 fund strategy, and I don't know that we've -- again --
19 speculative --

20 Q What if he says there is no hedge fund?

21 A What if he says there is no hedge fund?

22 Q What if Madoff Securities says that there's no
23 hedge fund. All the trading is taking place in these
24 brokerage funds. Would there be any records that you
25 couldn't get?

1 A Oh, no. If it was all through the broker-dealer,
2 then you could get everything, yeah.

3 Q Okay.

4 MR. KOTZ: All right. I'm going to show the March
5 4, 2004 memo.

6 (SEC Exhibit No. 10 was marked for
7 identification.)

8 BY MR. KOTZ:

9 Q And this is a March 4, 2004 memo to Dan Gray from
10 Lori Richards, John McCarthy, Eric Swanson, Mark Donahue, and
11 you, Exhibit 10. Is this your memo?

12 A Yes.

13 Q Okay. So you say in here, "Staff finds that Madoff
14 may be misappropriating material non-public information
15 relating to customer orders, and allowing the funds to profit
16 from this order flow data. It's in violation of various
17 anti-fraud provisions of the Exchange Act as well as NASD
18 rules."

19 Do you know what the basis for that conclusion was?

20 A I don't have a lot of independent recollection of
21 what's in this memo, so I'm probably going to have to just
22 reiterate what's in there to support any, sort of, statement.

23 And I -- and also just -- I'm not sure -- and
24 obviously this -- I was asked to draft a memo in February 27,
25 2004, and then pretty quickly it looks like a memo was given

1 Q -- the files were in boxes and shipped up to NERO.

2 A Okay.

3 Q My question I guess is, how could it be that during
4 that period of time where you have open questions, Mark
5 Donahue relates. Eric Swanson talks about suspicions.
6 Genevieve Walker is concerned about information that
7 Madoff's saying that's not being necessarily reliable. That
8 is it -- how could it be that then nothing happened on the
9 case for a matter of many months?

10 A Yeah. I don't know.

11 Q I mean, did it happen every once in a while, that a
12 case, an exam was being worked on, and then all of a sudden
13 they just moved on to other priorities and nothing really
14 happened on that exam for --

15 A Yes.

16 Q -- the year? Yes?

17 A Well -- I'm sorry. I should have waited till you
18 finished. A year might be stretching it, but obviously
19 during -- while you were working on things, and prioritizing,
20 there might be inactive periods on examinations.

21 But I don't have -- I don't know why in this
22 particular case there was a year wait, based on the e-mails
23 that you gave me, between activity on the project and then an
24 absence of activity on the project.

25 Q Okay. But while you would say that there are time

1 periods when an exam, say, just sits without work being done
2 because of priorities, is it fair to say that this time
3 period, 11 months, is a particularly long time where an exam
4 might sit.

5 A Yeah, that's a pretty long time.

6 Q Okay. But there are cases where exams would sit
7 for several months?

8 A Yes.

9 Q All right. I'm going to show you the next e-mail.
10 This is a May 26, 2005 e-mail we're going to mark as Exhibit
11 20.

12 (SEC Exhibit No. 20 was marked for
13 identification.)

14 BY MR. KOTZ:

15 Q If you see, this is an e-mail, 5/26/2005, from Eric
16 Swanson to Mark Donahue, and this is the continuation of the
17 previous e-mail.

18 A Okay.

19 Q We have Eric Swanson saying to Mark Donahue on May
20 26, 2005, "Can you refresh my recollection about what we did
21 with this exam? I know we talked about it the other month,
22 but I forget."

23 Mark Donahue to Eric Swanson, "Nothing's happened
24 since we last spoke. I will gather the stuff and figure out
25 what we have. The article's from 2001, so they probably have