



1 THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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3 In the Matter of: )

4 ) File No. OIG-509

5 OIG-509 )

6

7 PAGES: 1 through 53

8 PLACE: Securities and Exchange Commission

9 100 F Street, N.E.

10 Washington, D.C. 20549

11 DATE: Tuesday, April 7, 2009

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13 The above-entitled matter came on for hearing, pursuant  
14 to notice, at 10:00 a.m.

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24 Diversified Reporting Services, Inc.

25 (202) 467-9200

□

[REDACTED]

1 APPEARANCES:

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3 On behalf of the Securities and Exchange Commission:

4 HEIDI STEIBER, Investigator

5 Securities and Exchange Commission

6 100 F Street, N.E.

7 Washington, D.C. 20549

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10 On behalf of the witness:

11 [REDACTED], PRO SE

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C O N T E N T S

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3 WITNESS: [REDACTED]

EXAMINATION

4 [REDACTED]

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P R O C E E D I N G S

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MS. STEIBER: Just to go back, you were telling us  
3 about a meeting from late '97.

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[REDACTED]: All right. So we had -- we had a  
5 meeting either in late '97 or early '98 with Bernie Madoff

6 and I believe it was [Personal Privacy] from Fairfield Greenwich in  
7 the offices of Madoff Securities.

8 And during that meeting, Bernie described his  
9 investment strategy, which basically involved, on a once- or  
10 twice-a-month basis, the traders would determine that, you  
11 know, the market feels like it's going up; I want to buy a  
12 basket of stocks for these accounts. And that basket of  
13 stocks was sort of 30 to 35 large cap U.S. equities. The  
14 basket would highly correlate to the S&P 100, also known as  
15 the OEX 100.

16 And what they would do is they would collar the  
17 risk in what they would call split strike conversion.  
18 Typically, in the option world, we call it a risk reversal.  
19 And what they would do is they would sell calls on the  
20 OEX 100 and they would buy puts on the OEX 100, short-dated  
21 options, you know, to basically collar the risk of that long  
22 position in the basket.

23 So the problem that I -- that I identified in that  
24 one meeting was I asked -- I asked [Personal Privacy] and Bernie to  
25 explain the nature of the funds. And I said, let me get this

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1 straight. The Fairfield Century funds has a discretionary  
2 brokerage account with Madoff Securities. And the answer was  
3 yes.

4 And that in itself is fine. Right? So basically,  
5 the fund had a discretionary account with the securities  
6 firm, and the securities firm had discretion to trade the  
7 account. My question to Bernie was, who does the  
8 discretionary account have an ISDA with? And here's what an

9 ISDA is.

10 ISDA is -- what I was referring to was an ISDA  
11 master agreement. An ISDA is the International Swap Dealers  
12 Association. Right? And a master agreement is what you put  
13 in place so that counter parties can trade over-the-counter  
14 derivatives with one another. All right?

15 MS. STEIBER: Okay.

16 [REDACTED]: So it's an agreement that defines the  
17 terms of trading over-the-counter derivatives. So what I was  
18 asking Madoff was, you know, you're trading all of these OEX  
19 options -- and you have to remember, back in '97/'98, I think  
20 they described the strategy, meaning not only Fairfield's  
21 account but, you know, numerous other managed accounts, at  
22 the time was roughly 3 billion U.S. that was being managed  
23 this way. All right?

24 So assets under management for Madoff Securities in  
25 this strategy were about 3 billion. And so what I wanted to

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1 know is, who were you trading these options with? And  
2 Madoff's reply to me was, we don't have an ISDA master  
3 agreement for the account. And I said, well, that's odd.  
4 Who do you trade the options with?

5 Because my -- I immediately figured that all the  
6 options were being traded over the counter. All right? And  
7 Bernie explained to me that -- he said, no. What we do is  
8 none of the options are traded over the counter. The options  
9 are traded through the Chicago Board of Options Exchange so  
10 that we have the clearinghouse of the options exchange as our  
11 counter party.

12                   ██████████ And I said, oh, that's interesting. Now, Heidi, do  
13 you understand what I'm saying?

14                   MS. STEIBER: I do. And I would love for you,  
15 after you explain it all to me --

16                   ██████████: All right.

17                   MS. STEIBER: -- to then tell me about your options  
18 background.

19                   ██████████: Okay.

20                   MS. STEIBER: How you knew this.

21                   ██████████: So what Bernie was basically saying is  
22 that instead of -- you know, considering the size of the  
23 amount that they were managing, instead of the firm going out  
24 and trading a large block with Merrill Lynch or Goldman  
25 Sachs, what Madoff explained was they would pre-negotiate the

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1 trade with Merrill Lynch, Goldman Sachs. He said, every  
2 street firm I trade with.

3                   And then they would cross the trade on the Chicago  
4 Board of Options Exchange, meaning that the options were  
5 clearing through the exchange. And that ended up being the  
6 counter party. And for that reason, a discretionary account  
7 did not have to have an ISDA master agreement in place with a  
8 broker. Okay?

9                   MS. STEIBER: Did you find anything odd about him  
10 saying this?

11                   ██████████: Well, I found something exceptionally  
12 odd about that because in my experiences working at

13 Personal Privacy ██████████, I knew that the Chicago Board of  
14 Options Exchange, their OEX picks -- in other words, where

15 they actually physically [REDACTED] traded those options -- was not a  
16 very deep market. It was not. It was basically, you know,  
17 something that we would call a retail market.

18 And so the problem was, immediately what I asked  
19 Madoff was: How are you doing that? Because I don't think  
20 there's enough volume on the Chicago Board of Options  
21 Exchange for you to get that sort of coverage for amount that  
22 you're managing. You're managing 3 billion. And at  
23 3 billion, you'd probably have to do 50- to 100,000 options.  
24 And on any given day, there's not enough volume.

25 MS. STEIBER: And you know the volume trading on

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1 CBOE just by looking in the newspaper. Is that correct?

2 [REDACTED]: You can looking at it on Bloomberg in  
3 a heartbeat. You can -- you know, that sort of information  
4 is readily available. And in fact, what was fascinating was  
5 I -- so the fun part about it, I guess, is that Madoff  
6 explained to me that I didn't understand how the options  
7 exchanges work. And then I mentioned to him that I had  
8 worked at [REDACTED] and that my desk [REDACTED]  
9 [REDACTED] and I think I knew how the  
10 options exchange worked.

11 You know, the problem was that on any given day,  
12 there might be, you know, 20- to 30,000 options traded in the  
13 OEX picks, maybe even 50,000 options. But it's rare that  
14 it's only one customer. Right?

15 MS. STEIBER: Right.

16 [REDACTED]: And given the size of his -- you know,  
17 the assets under management, he would have needed that many.

18 Because the OEX options are only on a hundred -- you know,  
19 it's a \$100 multiplier. So these are small trades. These  
20 are retail -- sort of retail trades.

21 If he had said -- if he had said, I'm trading S&P  
22 500 options on the Chicago Mercantile Exchange, he would have  
23 been a bit more credible because that market's very deep.  
24 It's much deeper than the Chicago Board of Options Exchange.

25 So I said, all right. Well, I left that meeting

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1 and I had an issue with the fact that he was trading  
2 everything on the CBOE, the Chicago Board of Options  
3 Exchange. I didn't -- I didn't actually think that there was  
4 enough volume on the exchange. And he had told me that he  
5 was trading with the street.

6 Now, you asked about my background in derivatives.  
7 You know, I started my career in [REDACTED] in [REDACTED]. Do  
8 you remember that there was a [REDACTED] Personal Privacy ?

9 MS. STEIBER: I've heard the name.

10 [REDACTED]: All right. [REDACTED]  
11 [REDACTED]. I worked there through '89 in their -- in developing  
12 sort of new financial products in derivatives. And then I  
13 moved to [REDACTED] in Chicago, and [REDACTED] personal privacy  
14 [REDACTED] personal privacy

15 [REDACTED]  
16 And -- but our firm was [REDACTED] Personal Privacy

17 [REDACTED] And it  
18 was -- it was a phenomenal experience, and you had to learn  
19 how to trade on the exchange. You had to -- you know, you  
20 really -- you lived and breathed options.



21                   ██████████ And our firm was a major member of the Chicago  
22 Board of Options Exchange. And at one point, **personal privacy**  
23 **personal privacy** ██████████ for what happens in the  
24 event of mergers and stock dividends and rebalancings of  
25 stock parameters as it relates to the underlying options. So

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1 Personal Privacy  
2 ██████████  
3 ██████████

3                   And so I went back, and after that meeting I  
4 actually gave a call over to some people at the Chicago Board  
5 of Options Exchange. I asked them to help me get a feel for  
6 how much volume trades on a daily basis. They sent me some  
7 data. I don't have that data any more, but there's a lot of  
8 stuff that you can -- you can actually download from the  
9 Chicago Board of Options Exchange. In fact --

10                   MS. STEIBER: what could you have downloaded?

11                   ██████████: well, actually, back in '97, with the  
12 fact that the internet was not -- you know, was just getting  
13 going --

14                   MS. STEIBER: Right.

15                   ██████████: -- I don't know if there was -- you  
16 couldn't directly answer the question. But the thing is --

17                   MS. STEIBER: well, what about '93/'94/'95? I'm  
18 sorry for interrupting.

19                   ██████████: No. I'm talking '97/'98. But the  
20 thing about it, Heidi, is that the Board of Options Exchange,  
21 every exchange wants to promote their -- they want to promote  
22 their volume. You know, they want to show that they're big  
23 players in this market.

24                    [REDACTED] that regardless of whether or not  
25 you physically traded on the exchange or if you cleared

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1 through the exchange by sort of prearranging the trade off-  
2 market and then, you know, doing it through the exchange,  
3 either way the Board of Options Exchange would have printed  
4 those numbers because they have a vested interest. They get  
5 a -- you know, the exchange gets a little bit of money every  
6 time you trade on it. Right?

7                    MS. STEIBER: Right. And --

8                    [REDACTED]: So for them to be viable, every trade  
9 gets counted. And the volume just was not there. So if you  
10 look back -- and in fact, you could download off of Bloomberg  
11 today -- I think off of Bloomberg, or definitely off of  
12 probably the CBOE website, you can download the daily call  
13 and put volume, right, for the OEX picks. And the problem  
14 is -- the problem is that the volume was never there for  
15 Madoff. So that was problem No. 1 for me.

16                    Problem No. 2 was -- and this is something that,  
17 you know, not -- I don't think a lot of people had access to  
18 in terms of information. But I called up buddies of mine  
19 around the street who were now running the equity derivatives  
20 departments of a number of firms, and I asked them all if  
21 they were trading with Madoff.

22                    And nobody was. Nobody was doing these OEX  
23 options. And in fact, the funny part about it was they all  
24 said, yeah. You know, I hear that he's doing all these  
25 trades but, you know, we don't see it anywhere and we knew

[REDACTED]

2 as much as they described the strategy, nobody did the  
3 options. And so I just grew a higher level of disdain for  
4 this whole thing as time went on. I could never find anybody  
5 who remotely even knew who was doing the options.

6 And it made me think that, you know, what could be  
7 possibly going on. The only thing I could think of was  
8 either maybe they are trading the equity since, you know,  
9 Madoff Securities is a fairly large market maker. So maybe  
10 they're trading the underlying and they're running sort of a  
11 dual set of books with, you know, phantom accounting on the  
12 options.

13 That could be like the only potential explanation.  
14 And I could never get my hands around it, and it never  
15 interested me enough to kind of pursue it because I wasn't  
16 going to put money with them anyway.

17 MS. STEIBER: Now, you had said that he -- that  
18 Madoff claimed to be trading on an exchange. What if a  
19 regulator went to him based on, you know, this information  
20 and he said, no, actually I'm trading over the counter? What  
21 would be -- you had mentioned that, you know, if --

22 [REDACTED]: Heidi, you're asking -- you're asking  
23 great questions. And let me -- I'm going to tell you what I  
24 tell everybody else. And some of it you're going to like to  
25 hear. Some of it you may not like to hear.

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1 MS. STEIBER: Okay.

2 [REDACTED]: Have you -- you've been on the general  
3 counsel side. Have you ever been on a physical audit?

4 MS. STEIBER: No, I haven't.

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