



MEMORANDUM

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

TO: Dan Gray

FROM: Lori Richards, John McCarthy, Eric Swanson, Mark Donohue and Matt Daugherty

RE: Bernard L. Madoff Investment Securities, LLC

DATE: March 11, 2004

I. Introduction

Relevant to the Staff's ongoing examination with respect to Bernard L. Madoff Investment Securities, LLC (and related parties and affiliates) ("BLM") is the issue as to whether BLM, by virtue of operating certain accounts it has described as "hedge funds", would be considered an Investment Advisor under the Investment Advisors Act of 1940.

II. Facts

On the "Trading Authorization Directive" forms signed by the funds, it states that purchases and sales will be directed through the execution parameters coded in an electronic program developed by Bernard L. Madoff Investment Securities LLC (BLMIS). It also states that Bernard Madoff (individual) ("Madoff") will not "exercise any investment discretion as to the selection of securities...purchased or sold by or for the account", and that Bernard Madoff will determine the time at which specified orders are executed as derived from the program results. As per the terms on the form, the funds are considered "clients" of BLMIS. It seems clear from the form that BLMIS has absolute discretion over the account (i.e., the client cannot trade on his own). As to fees and expenses, the form states that there are none charged by BLMIS or Bernard Madoff other than a commission of \$.04 per share on equity transactions and \$1.00 per share on option transactions by BLMIS. Bernard Madoff himself has categorically denied being an investment advisor to the Staff on numerous occasions.

III. Analysis

A. Definition of Investment Advisor and Registration Requirements

DIVISION
EXHIBIT

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Under the Advisor's Act, the term investment advisor means any person who, (1) for compensation, (2) engages in the business of (3) advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities..." - subject to certain exclusions.¹ Additionally, Section 203 requires all persons who meet the definition of an investment advisor and are not excluded from the definition to register with the Commission, unless they fall within certain exemptions from registration. The analysis to be performed in this case is whether BLMIS meets the definition of an investment advisor (and is not excluded), and if so, whether they should be registered with the Commission.

B. BLMIS as an Investment Advisor Under the Act

While the firm is a registered broker-dealer, its (or its affiliates or principals) activities with respect to its hedge funds arguably place it under the definition of an advisor under the Advisors Act. The analysis here centers on the three basic requirements that must be met under the Act to fall within the definition.

With respect to the first, compensation, the receipt of any economic benefit suffices, and it need not be in the form of an advisory fee, but can be in the form of a commission.² Accordingly the "fee" earned by BLMIS, which as noted in the agreement is in the form of a commission, falls within the generally construed meaning of the term.

Secondly, whether a person or firm is "engaged in the business of" giving investment advice depends on facts and circumstances of each particular case, but pursuant to Commission releases, the staff from Division of Investment Management considers a person to be "in the business of" giving advice when the person "receives transaction based compensation if the client implements the investment advice."³ In that BLMIS receives "transaction based compensation" in the form of commissions when its "investment advice" is implemented by virtue of the split-strike conversion strategy signaling a purchase or sale, BLMIS also fit this portion of the definition.

Finally, BLMIS is giving "advice" concerning securities via its strategy formulation, by buying specific securities at opportune times, to which the clients (hedge funds) have already agreed.

C. The Broker-Dealer Exemption

Although BLMIS may fall squarely within the definition of investment advisor under the Act, Section 202(a)(11)(C) states that any broker or dealer whose performance of such services is (1) solely incidental to the conduct of his business as a broker or dealer and who (2) receives no special compensation therefor is excluded from the

¹ Section 202(a)(11) of the Investment Advisors Act of 1940.

² Release No. IA-1092, October 8, 1987.

³ Id.

definition of investment advisor. As such, BLMIS may make the argument that its activities with respect to the hedge funds are only those normally engaged in by a broker-dealer, and accordingly, it is excluded from the definition. The exception "amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business,"⁴ however, there are certain thresholds a broker-dealer cannot cross in order to avoid having to register as an advisor. Ultimately, one's status depends on the issues of "solely incidental" conduct and "special compensation."

BLMIS would have support for a contention that the operation of the accounts are "solely incidental to the conduct" of the business as a broker. Its general contention is that it is simply executing orders as a broker-dealer for the funds. Ultimately, the issue hinges on BLMIS trading authority. It is clear from the forms that BLMIS has absolute discretionary authority over the purchasing or selling of securities, and that the fund only invests based on pre-programmed parameters set by BLMIS.

In its 1978 release, the Commission noted that historically broker-dealers who have exercised discretionary authority over the accounts of some of their customers were generally regarded as giving investment advice "incidental" to their business. However, it noted at that time that relationships which include discretionary authority to act on a client's behalf have many of the relationships to which the protections of the Advisor's Act are important, and that it was considering whether to take action to interpret the exclusion as inapplicable to a broker-dealer who exercises "investment discretion" as defined in Section 3(a)(35) of the Exchange Act.⁵ While not passing a rule to this effect, the Commission has reiterated its position that "broker-dealers whose business consists almost exclusively of managing accounts on a discretionary basis are not providing advice solely on an incidental basis, and thus are subject to the Advisor's Act."⁶ In this case, a strong argument can be made that Madoff's absolute discretion over the fund assets make the relationship more analogous to that of a fund manager than to a broker.

Generally, "special compensation" has been meant to include something more than just ordinary brokerage commissions, unless a "clearly definable" part of the commission is for investment advice.⁷ Thus part of the analysis here may turn on whether the commission BLMIS charges of \$.04 cents per share is higher than that normally charged, and whether that extra charge would be deemed "special compensation" which would preclude it from relying on the exemption. However, in order to meet the exemption both parts listed above must be met, thus even if the commissions charged by BLMIS are not deemed special compensation, it may fail to

⁴ Id.

⁵ 1978 WL 196894 (SEC Release No. 34-14714, IA 626).

⁶ Release No. 34-42099; IA-1845, See also, E.F. Hutton & Company, Incorporated, SEC No-Action Letter, February 2, 1979.

⁷ Id. See also, 1978 WL 196894 (SEC Release No. 34-14714, IA 626)

meet the exemption by virtue of giving advice which is more than just incidental to its operation as a broker.

D. Registration as an Investment Advisor and Operation of an Unregistered Investment Company

It may be that BLMIS will claim that while it meets the definition of an investment advisor under the Act, it is not required to register under the exemption provided in Section 203(3). Under Section 203(3), investment advisors who have fewer than 15 clients and who neither hold themselves out generally to the public as an investment advisor are not required to register. Under current Commission rules investment advisors may count "legal organizations", such as hedge funds, as a single client.⁸ Thus, BLMIS may claim that as the advisor to hedge funds, he is not required to register.

Based on the information provided so far, there may be an issue as to whether BLMIS is properly relying on this exception. First, documents provided show that it may be managing at least 16 hedge funds, which even assuming arguendo that it has no other clients, puts BLMIS outside the scope of the exception.

Additionally, hedge funds meet the basic definition of an investment company, but are formulated under one of 2 exemptions to the rule. Under the exemptions, there are various limits as to how hedge funds can be structured and operated, for instance, under Section 3(c)(1), a fund cannot have more than 100 investors. If a fund has more than 100 investors, the operator has violated statutes against operating an unregistered investment company, and if the advisor is not registered, and arguably violated the Advisor's Act by operating an investment company and/or advising more than 14 clients without registering. Until the Staff receives more information concerning the shareholders or clients to the funds, no determination can be made as to whether the hedge funds are meeting these exemptions.

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Rule 203(b)(3)-1.