MEMORANDUM

To: Robert A. Sollazzo
   Associate Regional Director
Richard D. Lee
   Associate Regional Director

From: Dorothy A. Eschwie
   Assistant Regional Director

Date: April 22, 2004

Subject: E-mails obtained during IA examination

During a routine investment adviser examination of Investment Adviser #1, one of our staff accountants, Thomas Thanases, obtained certain e-mails and brought them to the attention of his branch chief, Diane Rodriguez. Since questionable activity on the part of Bernard L Madoff Investment Securities LLC ("Madoff"), a registered broker-dealer, is mentioned in these e-mails, we are providing the attached copies for your information. Our review does not indicate that Madoff is a registered investment adviser.

The examination of Investment Adviser #1 is ongoing and additional information has been requested in order to complete the examination. After you have reviewed the attached, please let me know if there is anything further that you would like the investment adviser examination staff to do.

Cc: Diane Rodriguez
Rodriguez, Diane G.

From: Thanasules, Thomas
Sent: Wednesday, April 21, 2004 10:38 AM
To: Rodriguez, Diane G.

Diane, for some reason I am unable to copy that part of the heading, however, the first e-mail I sent you is from Investment Adviser #1 Portfolio Manager.

The second e-mail included in my first e-mail to you is from Investment Adviser #1 Scientist.

The third e-mail with the analysis of the option trading is from Investment Adviser #1 Risk Manager.
Good afternoon Diane,

I wanted to inform you that I have started reviewing the e-mails they have provided. Certain e-mails have come to my attention that appear to raise questions regarding another entity named, Bernard L Madoff Investment Securities. ("Madoff"). As far as I know right now Madoff is a registered broker-dealer. In brief, my IA has entered into a total return swap agreement with another entity whereby one of the underlying investments is an account that appears to be managed by Madoff. As I am reviewing these e-mails there is some back and forth regarding an underlying investment in the Madoff account as follows:

Committee members,

We spoke to an ex-Madoff trader (who was applying for a position at our firm) and he said that Madoff cherry-picks trades and "takes them for the hedge fund". He said Madoff is pretty tight-lipped and therefore he didn't know much about it, but he didn't really know how they made money. I heard a similar story from a large hedge fund consultant who interviewed an ex-trader. The head of this well-respected group told us in confidence that he believes that Madoff will have a serious problem within a year. We are going to be speaking to him in 11 days to see if we can get more specifics.

Another point to make here is that not only are we unsure as to how Madoff makes money for us, we are even more unsure as to how Madoff makes money from us; i.e. why does he let us make so much money? Why doesn't he capture that for himself? There could well be a legitimate reason, but I haven't heard any explanation we can be sure of. Additionally, there is a $4 billion Madoff pass-through fund (Fairfield Sentry) that charges 0 and 20% and it's not clear why Madoff allows an outside group to make $100 million per year in fees for doing absolutely nothing (unless he gets a piece of that). The point is that as we don't know why he does what he does, we have no idea if there are conflicts in his business that could come to some regulator's attention. Throw in that his brother-in-law is his auditor and his son is also high up in the organization and you have the risk of some nasty allegations, the freezing of accounts, etc., etc. To put things in perspective, if they went to zero it would take out 80% of this year's profits.

Perhaps the best reason to get out is that we really don't expect to make an outsized return on this investment. Sure it's the best risk-adjusted fund in the portfolio, but on an absolute return basis it's not that compelling (12.16% average return over last three years). If one assumes that there's more risk than the standard deviation would indicate, the investment loses its luster in a hurry.

It's high season on money managers, and Madoff's head would look pretty good above Elliot Spitzer's mantle. I propose that unless we can figure out a way to get comfortable with the regulatory tail risk in a hurry, we get out. The risk-reward on this bet is not in our favor.

Please keep this confidential.
Committee members,

I share the concern about the investment.

In note, I am most worried about the new information in the statement from the ex-Madoff trader to the effect that "Madoff cherry-picks trades and 'takes them for the hedge fund'. We at have totally independent evidence that Madoff's executions are highly unusual.

I do not know what to make of the consultant saying "Madoff will have a serious problem within a year."

In all, I very much agree with the sentiment "It's high season on money managers, and Madoff's head would look pretty good above Elliot Spitzer's mantle. I propose that unless we can figure out a way to get comfortable with the regulatory tail risk in a hurry, we get out. The risk-reward on this bet is not in our favor."

A last quote, from I believe: "If you are going to panic, panic early."

Diane, these are some e-mails I have reviewed. At this point I spoke to the compliance officer regarding Madoff who informed me that they have reduced their investment in this vehicle but not due to anything referenced in the aforementioned e-mails. At this point I do not know any further details, however, I am currently putting together a request list, asking for due diligence folders, type of information they receive regarding their investment, etc.

Anyway, I will call you in a few minutes to hear your thoughts. Thank you.
I have kept this note to a restricted circulation:

I had some further conversation with [name redacted] on the Madoff data. I also looked at some daily volume data on and around the OEX option transaction dates as indicated by Madoff's statements.

I was specifically trying to address the question of how big a fund base can Madoff trade with this strategy - numbers were thrown out the other day between $5bn and $15bn - by focussing on the option volume numbers.

1. Recall that Madoff's strategy involves a collar, that is a put and a call. The volume numbers provide total calls executed on the OEX and total puts. In the two independent set of statements which analysed the strikes were always the same for both accounts. Make the generous assumption that 50% of the volume was in the most liquid strike (it seems to average 25-25%).

By this measure Madoff could only do $750m. That is with him doing 100% of the option volume in his chosen strike (with the generous 50% assumption). Lets assume that he spreads it over 3 days - so we get to 2.1bn - still far short of the target numbers.

2. Another important point: In every case that we examined the option strike (call) is the one closest to the close in the underlying market. Of course the market close is not known until the close!! Does this mean that all the options are done almost at the close?

3. The volume does seem to spike on the days that Madoff is executing, on the days we examine by a factor of 3-4. This must produce a deterioration in execution prices - and for 15bn!

4. When we examined this issue before, we concluded that maybe he does the options in the OTC market. We have spoken to several market makers in OTC equity options, none of them claim to see any significant volume in OEX options. Recall that Madoff stated that Madoff had said it was necessary to spread trades over several days - why if you are doing OTC?

5. Recall point 2. This would indicate that the OTC options would also have to be done at the end of the day (to get a strike near the close). Are we to believe that the market makers would take on $15bn of market risk at the close? Of course they might (might!!!) be willing to take the option risk if Madoff provided the market hedge in the underlying (ie they did the whole package with Madoff) but we already know that the trades in the underlying, compared with the closing prices, would leave the OTC counterparty showing losses (as our account always shows gains).

6. Of course ALL of our trades are with Madoff as the principal - so our option positions are OTC
with Madoff so he can choose to use any strike, and any total volume he chooses, but the risk must be covered somewhere if he is doing these trades at all?

So we need an OTC counterparty (not necessarily a bank) who is willing to do the basket of the options plus the underlying with Madoff at prices unfavourable for the OTC counterparty - in 10-15bln!!

Any suggestions who that might be

None of it seems to add up.

Investment Adviser #1 Risk Manager
Good Morning Diane,

I just wanted to clarify that their outside legal counsel is Katten Muchin Zavis Rosenman. The initials RB in the e-mail that I forwarded to you are those of an employee of the Investment Adviser. Yesterday, I talked to them about the e-mails I informed you about and they informed me that the employees who wrote the e-mails attended some type of conference where there was some chatter regarding Madoff. However, as far as they know it is unsubstantiated. In brief, I was informed that the individuals who wrote the e-mails just overreacted and that the IA still has money in that investment however they have decided to reduce it because of the rate of return and to reduce its size in its client's portfolio not because of the "chatter". I put in the request we mentioned yesterday regarding the due diligence files and some other items. I will keep you posted of any new developments. Thank you.
That e-mail was a reference to my IA's hedge funds.