Bernie's fessing up. I could only access part of the memo, but it sounds like we may have something to review (directed executions). You wonder what is his benefit beyond commissions.

----Original Message-----
From: Nee, John Personal Privacy
To: Sollazzo, Robert A. Personal Privacy
Sent: Thu May 26 16:38:51 2005
Subject: FW: Meeting with Berine

Bob,

FYI (We are following up with more requests including trade info.)

Hey John,

Attached is a rough-draft write-up for the meeting that William and I conducted yesterday with Bernie. I am still waiting to receive the agreements between Madoff and the funds.

Pete
Summary:

The staff conducted an interview on May 25, 2005 with Bernard Madoff ("BMadoff"), Chairman, to discuss Madoff's business in relation to two articles written about the firm in Marhedge and Barrons in 2001. Before the articles were mentioned to BMadoff by the staff, he stated that the firm did not conduct any management of outside money, nor did the firm serve as an Investment Advisor or provide any investment advice.\(^1\)

When the staff mentioned the Marhedge and Barrons articles, BMadoff stated "we do execute trades on behalf of brokerage firms and institutions which include a number of hedge funds. They use a model (algorithm) that we developed." Initially, BMadoff stated there were four hedge funds using the model including Fairfield Sentry, Thema, Tremont, and Kingate Global.\(^2\) Subsequently, BMadoff stated there were approximately 15 entities including the four hedge funds and two corporate accounts using the model. *The Trading Directive agreements between Madoff and these entities will be provided by the firm.*\(^3\) BMadoff stated that all investors are foreign investors and the accounts are all DVP/RVP. Madoff provides these entities with trade confirmations and month-end account statements which include all trading activity. *The staff will select a timeperiod and review the account statements generated during this timeperiod.* According to BMadoff, he is not an investor in any of these entities and he does not use the model to trade the firm's capital.

BMadoff developed the model approximately eight years ago and is the only individual authorized to execute trades on behalf of the 15 entities using the model. The model operates on a computer server separate from the rest Madoff's market-making and proprietary trading business.\(^4\) The model attempts to replicate the S&P 100 using a basket

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1. During an interview on April 28, 2005 with BMadoff, Peter Madoff, Chief Compliance Officer and Trading Floor Compliance Supervisor, the staff asked BMadoff if the firm has ever managed outside money. BMadoff stated "No, we are not that kind of firm."
2. According to BMadoff, Fairfield Sentry is affiliated with Citco, Tremont is affiliated with Bank of America, and Thema and Kingate Global are affiliated with HSBC.
3. BMadoff stated these agreements were the only written correspondence between Madoff and these entities.
4. The staff confirmed with BMadoff that the server is completely separate from the firm's Madoff Integrated Support System ("MISS") and the firm's automated market-making system nicknamed Robo.
of approximately 50 securities contained within the S&P 100. This basket-trading strategy is a long only strategy according to BMadoff. While the model does not incorporate short-selling, there is an attempt to “time the market” to maximize investment returns. According to BMadoff, the title of the strategy used by the model is split-strike conversion, which insinuates a strategy that uses options. However, BMadoff stated the model stopped using options approximately one year ago. The entities that allocate capital to the model cannot adjust the model, only the amount of capital allocated to it. The model has two aspects. One, it must identify the appropriate securities and number of shares of these securities to most closely replicate the S&P 100. Two, the model suggests the timing of entering and exiting the market using momentum signals. BMadoff was adamant that he also uses his “gut feel” to enter and exit the market. According to BMadoff, the shares are executed in Europe before the 9:30 am opening of the U.S. equity markets using various brokerage firm’s who bid or offer on the securities in the basket in an “auction system” format. While in the past, the model could implement the strategy in one day, now it can take three to five days. While other firms may have a similar strategy, BMadoff stated that the speed at which the strategy can be executed and the high correlation the basket has with the S&P 100 are the major components of the model’s competitive advantage. BMadoff stated the returns for the strategy since inception have been between 10% and 15% per year.

According to BMadoff, there was approximately six to seven billion dollars allocated to the model by the 15 entities in April, 2005. The firm’s compensation for conducting this business is four cents per share, which is incorporated in the execution price. The revenue generated from this business is reflected in the “Other Trading” line item of the firm’s FOCUS Report.

BMadoff explained that due to the compensation structure of this business, he does not consider himself an Investment Advisor. Therefore, he did not state that the firm managed outside money when previously questioned by the staff.

BMadoff was surprised that the staff was unaware that Madoff conducted this type of business since he had discussions regarding the firm’s hedge fund relationships with SEC officials approximately one and one-half years earlier.

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5 This seems to contradict his earlier statement that it may take three to five days to implement the strategy.
6 BMadoff stated that all entities are charged four cents per share.
7 BMadoff stated he had communicated with Lori Richards and John McCarthy regarding the firm’s hedge fund relationships. BMadoff stated that he would provide a copy of the correspondence between Madoff and the SEC regarding the matter.