

From: Suh, Simona
Sent: Monday, April 10, 2006 1:22 PM
To: [Redacted] Personal Privacy
Cc: Cheung, Meaghan S.; [Redacted] Personal Privacy
Subject: Certain Hedge Fund Trading Practices, NY-7563-A

[Redacted] Personal Privacy

I would like to consult with your Division staff on another matter involving a broker-dealer functioning as an investment adviser with respect to discretionary accounts. I am copying [Redacted] on this email because the issues and legal authorities here are similar to those in my questions about [Redacted] Law Enforcement which you forwarded to Ian last week.

In Certain Hedge Fund Trading Practices, NY-7563-A, we are looking into the activities of Bernard L. Madoff Investment Securities LLC ("BLM"), a registered broker-dealer based in New York. BLM has three areas of business: market making, proprietary trading, and institutional trading, which is the focus of our investigation. In BLM's institutional trading business, the customers, predominantly large hedge funds, open brokerage accounts at BLM and give BLM and its principal, Bernard Madoff ("Madoff"), trading authority over the accounts. The limitations on that authority are set forth in the two attached PDF files. BLM then trades the assets in these accounts pursuant to its proprietary trading strategy, which is a form of split strike forward conversion. The strategy has three aspects: (1) a computer program that creates and monitors potential baskets of equities; (2) Madoff's market timing judgment; (3) a hedge consisting of a collar of S&P100 index options. The computer program constantly searches for baskets of about 50 equities from the S&P 100 index whose historical performance would strongly correlate to the performance of the index as a whole. Once a potential basket is available, Madoff, based on his own judgment of market conditions - and possibly other data that we have not yet learned about - decides whether to "execute the strategy", i.e., whether to purchase the basket and to put in place the corresponding hedge. If Madoff decides to execute the strategy, then BLM purchases the basket of equities and also purchases and sells the options for the hedge. The positions then remain unchanged until the earlier of two events: (1) a signal from the BLM computer program that the correlation between the performance of the basket and the entire index is no longer sufficient; (2) Madoff's decision that it is time to sell. Once the positions are sold, customer assets remain invested in cash until the next time that Madoff decides to execute the strategy. The customers take no part in any of the trading decisions and only learn of the trades that occurred in their accounts after the fact, when BLM sends them trade confirmations and account statements.

We initially began looking at BLM's institutional trading business because of suggestions in the press that the returns reported by BLM's customers were too good to be true and that BLM could be engaging in some improper conduct, such as front-running or false reporting of returns. So far, we have not found evidence of any such wrongdoing. It does appear to us, however, that BLM's institutional trading business is actually investment advisory business and that BLM should be registered with the Commission as an investment adviser.

Madoff insists that BLM is not an investment adviser because: (1) BLM does not charge any performance- or asset-based fees, but only charges a "commission equivalent" of 4 cents per share on equity trades and a commission of \$1 per contract on option trades; (2) BLM's investment discretion is limited to timing and price of transactions by the terms of the two attached documents. These two documents are drafted by BLM, without any input from the customers; BLM simply presents these documents to the customers who accept them without any adjustments or negotiation. (In fact, a BLM officer testified that BLM would not be able to implement its trading strategy if different trading parameters had to apply to different customer accounts.) Based on the Advisers Act Rule 202(a)(11)-1, it appears to us that Madoff's position is without merit and, because none of the exemptions from registration apply, BLM is violating Section 203 of the Advisers Act by failing to register as an investment adviser. Our preliminary analysis of these issues is set forth in greater detail below. It is not clear to us, however, whether BLM was an investment adviser prior to the 2005 adoption of Rule 202(a)(11)-1, under the staff's views stated in 1978 Releases IA-626 and IA-6401. We would like to hear your thoughts on these issues.

Thank you and best regards,

Simona

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Personal Privacy



NY-7563 Ex. 3.pdf NY-7563 Ex. 2.pdf

Bernard L. Madoff Investment Securities: Failure to Register as an Investment Adviser in Violation of Section 203(a) of the Investment Advisers' Act of 1940.

A. Is BLM an investment adviser?

Yes. Section 202(a)(11) of the Advisers Act defines an “investment adviser” as “any person who, for compensation, engages in the business of 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, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.” 15 U.S.C. § 80b-2(a)(11). Excluded from this definition are, among other categories of persons not applicable here, (1) brokers or dealers whose performance of advisory services is “solely incidental” to the conduct of their business as brokers or dealers and who receive “no special compensation” for such services; and (2) persons designated as exempt by the Commission rules. 15 U.S.C. § 80b-2(a)(11)(C) & (E). Rule 202(a)(11)-1(b) promulgated under this Section, 17 C.F.R. § 275.202(a)(11)-1(b), provides that a broker or a dealer “provides advice that is not solely incidental to the conduct of its business as a broker or dealer within the meaning of section 202(a)(11)(C) of the Advisers Act” if that broker or dealer, among other things, “[e]xercises investment discretion ... over any customer accounts.” For the purposes of this provision, a person has “investment discretion” over an account if that person “is authorized to determine what securities or other property shall be purchased or sold by or for the account” or “makes investment decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions.” Section 3(a)(35) of the Exchange Act, 15 U.S.C. § 78c(a)(35). The term “investment discretion” “does not include investment discretion granted by a customer on a temporary or limited basis.” Rule 202(a)(11)-1(d) of the Advisers Act, 17 C.F.R. § 275.202(a)(11)-1(d). On adopting Rule 202(a)(11)-1, the Commission explained the exception for “temporary or limited” discretion as follows:

In such cases, the customer is granting discretion primarily for execution purposes and is not seeking to obtain discretionary supervisory services. Such discretion must be limited to a transaction or series of transactions and not extend to setting investment objectives or policies for the customer. For example, we would view a broker-dealer’s discretion to be temporary or limited within the meaning of rule 202(a)(11)-1(d) when the broker-dealer is given discretion:

- As to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security;
- On an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time not to exceed a few months; [FN180]
- As to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- To purchase or sell securities to satisfy margin requirements;
- To sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss on the original position;
- To purchase a bond with a specified credit rating and maturity; and
- To purchase or sell a security or type of security limited by specific parameters established by the customer.

Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523, IA-2376, 2005 WL 849053 (Apr. 12, 2005).

Here, BLM acts as an investment adviser to the institutional accounts. First, BLM for compensation engages in the business of advising others about the value of securities and the advisability of investing in them. The institutional clients pay BLM compensation in the form of commission equivalent of 4 cents per share on equities and commission of at most \$1 per contract on options. In exchange for this compensation, BLM (specifically, Bernard Madoff) decides when BLM's institutional clients should purchase and sell the baskets of equities created by BLM's proprietary software and the corresponding options, and also selects the strike prices for the options. Second, BLM's advisory services are not incidental to the conduct of BLM's business as a broker-dealer because BLM has the discretion over the institutional clients' accounts. Although account documents impose certain limitations on BLM's discretion, these limitations clearly do not rise to the level of limitations contemplated by Adviser's Act Rule 202(a)(11)-1(d), where "the customer is granting discretion primarily for execution purposes and is not seeking to obtain discretionary supervisory services."

B. Is BLM required to register under section 203(a)?

Yes. Subject to the limitations set forth in Sections 203(b) and 203A, Section 203(a) makes it "unlawful for any investment adviser ... to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser" unless that adviser is "registered under this section." BLM clearly uses the mails and means or instrumentalities of interstate commerce in connection with its institutional trading business. For example, BLM mails trade confirmations and account statements to its customers and their administrators. Additionally, BLM employees, including Bernard Madoff, use telephone to communicate both with their customers and with each other. (In fact, Bernard Madoff often places these calls from locations outside the United States.) Thus, if we can establish that none of the limitations of Sections 203(b) and 203A apply, we can also demonstrate that, by its failure to register as an investment advisor, BLM violated Section 203(a).

C. Does BLM qualify for any exemption from registration under Section 203(b)?

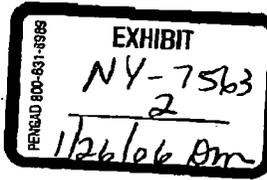
No. Section 203(b) establishes several exemptions from the registration requirement of Section 203(a). Not one of these exemptions, however, applies to BLM. First, Section 203(b) exempts from registration any investment adviser whose clients are all residents of the state where the adviser maintains its principal office and place of business and who does not advise about securities listed or admitted to unlisted trading privileges on any national securities exchange. This exemption does not apply to BLM because, first, many of his clients are foreign residents. For example, Fairfield Sentry Limited is a British Virgin Islands company. Additionally, BLM's services to the institutional customers concern exchange-listed securities, such as the equity securities from the S&P 100 index. Second, Section 203(b) exempts from registration "any investment adviser whose only clients are insurance companies." This exemption also provision also does not apply to BLM because its clients, such as Fairfield Sentry Limited, are hedge funds and not insurance companies. Third, an investment adviser is exempt from registration if, "during the course of the preceding twelve months," that adviser "had fewer than fifteen clients", and the adviser "neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser" to any registered investment company or business development company. This exemption also does not apply to BLM because, as of November 30, 2005, its institutional trading business had sixteen customers. Finally, BLM does not qualify for the remaining three exemptions under for Section 203(b) because: it is not a charitable organization; it is neither a church plan nor a church plan's affiliate or adviser; and it is not registered with CFTC as a commodity trading advisor.

D. Do any exemptions of Section 203A apply?

No. Section 203A and Rule 203A-1 thereunder exempt from registration certain state-regulated investment advisers if those advisers have assets under management of less than \$30 million and do not advise registered investment companies. This exemption does apply to BLM because the assets under management in its institutional trading business substantially exceed \$30 million. For example, in 2004-2005, Fairfield Sentry Limited alone allocated between \$4.3 and \$5.2 billion to its accounts managed by BLM.



BERNARD L. MADOFF
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TRADING AUTHORIZATION DIRECTIVE

Issued by: Account Name: American Masters Broad Market Prime Fund L

Account #: 1-C1260

This Trading Authorization Directive establishes the terms and conditions under which Bernard L. Madoff Investment Securities LLC (BLMIS) will execute the client's orders. The information contained herein pertaining to the order generation and execution parameters of the MA2.06 model is the proprietary intellectual property of BLMIS. The use or reproduction of this information or document for any other purpose is strictly prohibited.

Bernard L. Madoff (individual), acting as agent for the above referenced account, has not been granted, nor shall he exercise, any investment discretion as to the selection of securities or other property purchased or sold by or for the account. Bernard L. Madoff (individual) will determine only the time at which a specified order shall be executed. The purchase or sale of securities is limited as to issue and quantity, and shall include only executions that are consistent with the output results of BLMIS order generation and execution system software model MA2.06.

The core order/execution parameters of model MA2.06 are as follows:

- Orders generated shall be for no less than thirty-five (35) U.S. Equities, all of which must be resident within the highest fifty(50) percentile, based on market capitalization, of the Standard and Poor's 100 Index at the time of order entry.
- The sum total of the combined market capitalization of the equities to be executed must be in excess of seventy-five percent (75%) of the total market capitalization, as measured by Standard and Poor's, of the entire Standard and Poor's 100 Index .
- Each equity security shall be dollar weighted proportionately within the portfolio to the market capitalization of that particular issue in the Standard and Poor's 100 Index at the time of order entry.
- The resulting portfolio, when measured against the Standard and Poor's 100 Index, shall reflect an overall correlation of .95 to 1. These calculations, using a historical price data feed shall include a minimum of 200 data points that occur within a period of not less than twenty (20) trading days within the trailing thirty (30) day period.
- The portfolio, once executed, will be monitored for correlation variance using time interval pricing feeds. Random time intervals not to exceed 120 seconds shall be

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Madoff Securities International Limited

used as pricing data points for correlation variance calculations. The acceptable variance from the benchmark correlation shall not exceed five percent (5%).

- If the monitoring method set forth above indicates a condition where the variance has exceeded a 5 percent (5%) tolerance, price data point feeds will be advanced to real time (overriding time interval pricing) for a period not greater than 3000 seconds. If the correlation variance still exceeds stated tolerance, the model's predetermined orders to reverse positions will be exposed.

The dollar amount of the total order(s) to be calculated by the order generation system (as predefined by each client) and the resultant prorata allocation of executions, if necessary, are predicated on the total dollar amount of order(s) from all clients at the time the system model defines the necessary parameters are in place to attempt implementation of the strategy.

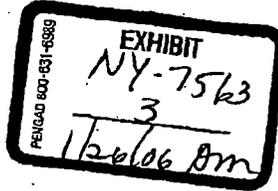
Transactions executed for the account will be average price, riskless principal transactions. A commission equivalent of four cents (\$.04) per share will be charged on transactions. The commission equivalents stated above will be BLMIS' only compensation. There will be no other fees or expenses incurred by the account.

Agreed to by: _____


Bernard L. Madoff Investment Securities LLC



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TERMS AND CONDITIONS FOR OPTION HEDGING TRANSACTIONS

Issued by: Account Name: AMER MASTERS BROAD MKT PRIME
 Account #: 1C1260

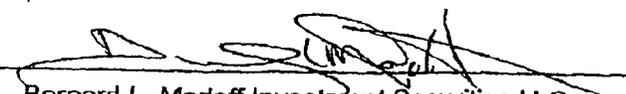
The following instructions establishes the terms and conditions under which Bernard L. Madoff Investment Securities LLC (BLMIS) will effect, as agent, the client's transactions.

Bernard L. Madoff (individual), acting as agent for the above referenced account, has not been granted, nor shall he exercise, any investment discretion as to the selection of securities or other property purchased or sold by or for the account. Bernard L. Madoff (individual) will determine only the price at which, or the time an option contract shall be effected pursuant to the instructions set forth below.

Upon establishment of equity positions for the account, an attempt to establish broad based index option contracts shall be made in accordance with the following conditions:

- The purchase of broad based index put options shall be limited to the S&P 100 Index, as calculated and disseminated by Standard and Poor's Corporation. The size of the contracts shall correspond to the total dollar value of the executed underlying equity positions. The time to expiration of the contract shall not exceed 60 days from the date of the underlying position order. If within the 60 day period there are multiple monthly expirations available, the contract priority shall be based on liquidity.
- Strike price of the put option shall be less (but not greater than 1.5% less) than the value of the S&P 100 Index at the point the equity orders are completed. If within the 1.5% index band, there are multiple strike prices available, the contract priority shall be based on liquidity. The resulting put option contract established shall be long "out of the money."
- The sale of broad based call option contracts shall be limited to the S&P 100 Index, as calculated and disseminated by Standard and Poor's Corporation. The size of contracts shall correspond to the total dollar value of the underlying equity position. The time to expiration of the contract shall not exceed 60 days from the date of the order. If within the 60 day period there are multiple monthly expirations available, the contract priority shall be based on liquidity.
- Strike price of the call option shall be greater (not to exceed 2.0% greater) than the value of the S&P 100 Index at the point the equity orders are completed. If within the 2.0% index band, there are multiple strike prices available, the contract priority shall be based on liquidity. The resulting call option contract established shall be short "out of the money".
- Upon liquidation of equity positions for the account, a corresponding amount of index option contracts shall be unwound.

Option transactions will incur a maximum commission of One dollar (\$1.00) per contract

Agreed to by: 
 Bernard L. Madoff Investment Securities LLC

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