

Bernard L. Madoff  
885 Third Avenue  
New York, NY 10022  
File # 8-08132  
Exam # 95-027

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## C O M M E N T S

A National Association of Securities Dealers, Inc. ("NASD") oversight examination of Bernard L. Madoff ("BLM") was conducted by the staff for the purpose of reviewing the registrant's financial condition, books and records, and sales practice activities. In addition, the examination served as a training vehicle for a new staff member of the NERO office.

### I. BACKGROUND INFORMATION

BLM has been registered with the Commission as a broker-dealer since January 19, 1960, as a sole proprietorship. BLM is a member of the NASD, as well as, the Cincinnati Stock Exchange ("CSE"). The firm computes net capital using the alternate method and is fully subject to the requirements of Rule 15c3-3. As of December 1994, the firm employed 40 registered representatives and 80 operations personnel. As sole proprietor of BLM, Bernard L. Madoff ("Madoff") acts as General Securities, Financial and Operational Principal. His brother, Peter Madoff, is the firm's Director of Trading, as well as, Registered Options Principal.

The firm executes between 15,000 and 20,000 transactions daily. The firm has achieved an average execution time of five seconds, by automatically routing orders via Computer to Computer Interface ("CTCI"). CTCI links 372 broker-dealers to BLM's automated system. In addition, CTCI links BLM's in-house computer system (STRATUS) with NASDAQ and allows simultaneous reporting of securities transactions internally for recordkeeping purposes, as well as, for trade reporting requirements. For a three month period, ending September 30, 1994, BLM had a total income of 26,909,793, relating primarily to trading activity.

### II. OVERSIGHT PERIOD FINDINGS AND COMMENTS

The NASD performed an oversight examination in February 1993. The period the NASD exam covered was from January 1992 through December 1992. The NASD exam focused on the member's computerized quotation system transactions for best execution, trade reporting and markups. The NASD staff utilized the 19c-3 Report and the Nasdaq Audit Trail to conduct their analysis. No material deficiencies were noted; therefore, the exam results were "filed without action."

The net capital calculation made by the NASD staff found that BLM had adequately allocated allowable and non-allowable assets. Both the NASD staff and BLM determined that, as of December 31, 1992, BLM's net capital was \$42,934,764 with a minimum of \$100,000 and an excess of \$42,834,764.

Personal Privacy [REDACTED] the NASD supervisor currently in charge of monitoring the firm, explained that the 1993 examination was most probably granted a waiver of all areas except

the best execution and trade reporting because the firm had no prior violations in the waived areas and that the firm had limited customer exposure.

### III. CURRENT PERIOD FINDINGS

#### A. Net Capital - Rule 15c3-1

BLM calculates net capital under the alternate method. The staff's review of the registrant's net capital computation and a comparison to the books and records, as of September 30, 1994, disclosed no material deficiencies. The following represent summary figures:

Total Allowable Assets	\$ 460,934,296
Total Liabilities	<u>(340,871,265)</u>
Ownership Equity	\$ 120,063,031
Total Deductions	<u>(879,784)</u>
Tentative Net Capital	\$ 119,183,247
Total Haircuts	(45,762,255)
Undue Concentration	<u>(8,105,900)</u>
Net Capital	\$ 65,315,092
Required Net Capital	<u>(1,000,000)</u>
Excess Net Capital	\$ 64,315,092

#### B. Reserve Formula - Rule 15c3-3

The staff reviewed the registrant's customer reserve formula, as of September 30, 1994, and found it to be in substantial compliance with the provisions of Rule 15c3-3. BLM's policy is not to accept any retail customers, however, the firm does maintain accounts for some employees as well as discretionary accounts for Madoff's family. All of these customer accounts were considered inactive during the staff examination period and no customer accounts had credit balances to be included in the Reserve Formula. However, BLM maintains a Reserve Bank Account, with a minimum of \$100,000 in order to comply with Rule 15c3-3, when activity in these accounts occur.

#### C. Sales Practice Review

The staff devoted 30% of the examination time reviewing the following areas.

##### 1. Due Diligence - Rule 15c2-11(c)

BLM makes a market in 395 listed securities, 108 of which are Rule 19c-3 securities (governing off-board trading by members of national securities exchanges). BLM also makes a market in 100 NASDAQ securities and warrants. The firm does not engage in any penny stock activity, bulletin board or pink sheet securities. The staff selected five securities, in order to review their due diligence files. The review did not disclose any material deficiencies, all files contained the information pertaining to the requirements of Rule 15c2-11(c).

## 2. Third Market Activity

According to Madoff, he is the largest Third Market dealer in the United States. The idea of creating this market emerged in 1975, when concern with greater competitive markets grew among regulators. Today, BLM is the New York Stock Exchange's ("NYSE"'s) largest competitor.

BLM executes approximately 385,000 trades a month. The average size of an order placed is 500 shares. BLM guarantees their customer the best execution price at the exchange. Furthermore, the firm processes inter-dealer transactions in an average of five seconds. BLM handles trades for approximately 372 broker-dealers, ranging from discount brokers, such as Charles Schwab, to full service retail firms, such as Merrill Lynch. On an average day, the firm generates about 80% of the CSE's volume, and 8% to 10% of the NYSE's volume.

BLM has created a highly sophisticated computer execution system that emphasizes efficiency in processing trades. This system executes buys and sell orders for its clients at the most competitive bid or ask on orders less than 3,000 shares. As a member of the CSE, BLM is able to participate in the Intermarket Trading System ("ITS"), which lists the best bids and asks offered in the NYSE and each of the accredited regional exchanges. By monitoring the ITS system, BLM is able to guarantee buy and sell orders at the best possible quote available from any exchange. After the order is placed, ITS searches for the most competitive price to execute the transaction, the client is sent a confirmation electronically, and BLM reports the trade to NASDAQ, all within five seconds of order placement. BLM not only offers their clients a quick and efficient service, but allows them to bypass the specialist commissions and "big board" fees charged by NYSE members. In addition, BLM gives brokers a rebate of one penny per share on orders of 3,000 shares or less.

Madoff considers this computerized system highly reliable. However, given that all operations rely on this sophisticated system, BLM operates a backup center, located in Queens, NY. This center is equipped to operate simultaneously or separate from the Manhattan location. All trades and computer terminals are identical to those in their main facility. This facility is designed to keep the current facility working, should the system or power fail in their Manhattan location. The Queens backup center is utilized on a daily basis by a group of employees, who rotate, to assess its operation.

## 3. Order Tickets

BLM has eliminated the need to produce physical order tickets, through its modernized computer system. The system enables the firm to readily retrieve trade data. The Trade Reconciliation Report includes information, such as cusip, symbol, broker-dealer, type trade, sell order, buy order, price, limit price, agency fee, principal fee, commission, and time. The staff requested to see a Trade Reconciliation Report for a specific date, and the report was generated immediately by the firm employees. The staff concluded that there is no problem in this area.

D. Miscellaneous

Additionally, the staff reviewed the following listed areas which yielded no significant discrepancies or inaccuracies on the part of BLM:

- a. Employee's personnel files;
- b. Fingerprints;
- c. Fidelity bond;
- d. Customer complaint file; and,
- e. U4 and U5 forms.

E. Insider Trading Act of 1988

A review of the registrant for compliance with the Insider Trading Act of 1988 revealed that the firm has adopted and implemented adequate written policies and procedures designed to monitor this area of concern.

F. Reporting of Currency and Foreign Transactions - Rule 17a-8

BLM maintains a policy of not accepting cash from clients. The staff reviewed the firm's operating accounts for deposits of currency greater than \$10,000. No instances of such deposits were detected, as well as, no instances of structuring deposits, in order to circumvent the requirements of Rule 17a-8. In addition, the staff queried the IRS's Currency & Banking Retrieval System for the period January 1992 to December 1994 for filings of Currency Transaction Reports. No filings were made by other parties which would indicate a requirement for BLM to make a filing.

G. Annual Audit

A review of BLM's certified annual audit report, dated October 31, 1993, indicated that the report has been filed in a complete and timely manner, in accordance with Rule 17a-5(d), and that it disclosed no material deficiencies in the registrant's system of internal control.

IV. CONCLUSION

Based upon the fact that the staff found the firm to be in substantial compliance, and did not disclose any relevant findings, during the review of both the oversight and the current periods, no further action will be necessary.