UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

ANWAR, *et al.*, Plaintiffs, v. FAIRFIELD GREENWICH LIMITED, *et al.*, Defendants. This Document Relates To: All Actions	Master File No. 09-cv-118 (VM)

PLAINTIFFS' CONSOLIDATED OPPOSITION TO
THE FAIRFIELD GREENWICH DEFENDANTS' MOTIONS TO DISMISS

BOIES, SCHILLER & FLEXNER LLP
575 Lexington Avenue
New York, NY 10022
(212) 446-2300

WOLF POPPER LLP
845 Third Avenue
New York, NY 10022
(212) 759-4600

LOVELL STEWART HALEBIAN JACOBSON LLP
61 Broadway, Suite 501
New York, NY 10006
(212) 608-1900

Interim Co-Lead Counsel for Plaintiffs

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PRELIMINARY STATEMENT

By their motions to dismiss, the FGG Defendants[1] seek to avoid responsibility for inducing thousands of investors around the world to invest billions of dollars in four investment vehicles managed by the FGG Defendants (the "Funds").[2] The Defendants in turn handed virtually all of those billions to Bernard Madoff with no meaningful pre-investment inquiry or post-investment oversight or monitoring. The FGG Defendants thereby provided the largest source of capital to the largest financial fraud in history. Defendants took hundreds of millions of investors' dollars as compensation while providing no discernible services. Yet they now seek to keep this undeserved windfall and avoid all liability for their reckless and fraudulent conduct. The Plaintiffs, meanwhile, have lost billions of dollars.

The Defendants are not being sued for their purported ignorance in not knowing Madoff was himself the world's biggest fraudster. The Defendants are liable because for at least a decade before 2008 they recklessly made utterly false statements, and omitted material information, in uniform sales documents distributed to thousands of investors. The false statements include: (1) that FGG's multi-billion dollar Funds had a track record of consistent returns; (2) that FGG took great care in selecting and supervising the Funds' investment

[1] This brief is a consolidated response to three motions to dismiss that were filed by all parties related to Fairfield Greenwich Group ("FGG"): (1) Fairfield Greenwich Limited, Fairfield Greenwich (Bermuda) Ltd., Fairfield Greenwich Advisors LLC, Walter M. Noel, Jr, Andres Piedrahita, Jeffrey Tucker, Mark McKeefry, Fairfield Risk Services Ltd., Amit Vijayvergiya, Fairfield Greenwich Limited, Daniel Lipton, and Fairfield Heathcliff Capital LLC, ("FGG Defendants") (citations to the FGG Defendants' memorandum of law in support of the motion to dismiss will hereinafter be referred to as "FG Br."); (2) Yanko Della Schiava, Philip Toub, Lourdes Barreneche, Cornelis Boele, Vianney Hendecourt, Harold Greisman, Jacqueline Harary, David Horn, Julia Luongo, Santiago Reyes, Lourdes Barrenche, Robert Blum, Corina Noel Piedrahita, and Maria Teresa Pulido Mendoza ("Fee Claim Defendants") (citations to the Fee Claim Defendants' memorandum of law in support of the motion to dismiss will hereinafter be referred to as "Fee Def. Br."); (3) Richard Landsberger, Charles Murphy, and Andrew Smith ("Other Fairfield Defendants) (citations to the Other Fairfield Defendants' memorandum of law in support of the motion to dismiss will hereinafter be referred to as "Other Def. Br.").

[2] The Funds are Fairfield Sentry Limited, Fairfield Sigma Limited, Greenwich Sentry, L.P., and Greenwich Sentry Partners, L.P.

managers; and (3) that FGG was undertaking rigorous measures to safeguard investments in the Funds. Each of these representations by Defendants about their own conduct was false, and Defendants knew they were false, or at the least recklessly made. And finally, it was not Madoff who made these false representations to the Plaintiffs; it was the FGG Defendants. Thus, it is Defendants' false statements about their own knowledge and activities that caused Plaintiffs to lose billions of dollars and are the foundation of this lawsuit.

The FGG Defendants have the temerity to suggest that they were themselves the "victims of Madoff's fraud" because they "lost tens of millions of dollars" they had allegedly invested with Madoff. What Defendants conveniently ignore, however, is the hundreds of millions of dollars that they took from Plaintiffs (and have refused to return) in the guise of "management" and "performance" fees for producing purported "profits" in Funds that never existed. (SCAC ¶ 236-49.) Far from being "victims," the FGG Defendants are among the greatest profiteers from Madoff's fraud.

Equally unavailing is Defendants' protestation that many others, including auditors and regulators, failed to uncover the fraud. (FG Br. at 2.) The SEC, which failed to uncover Madoff's Ponzi scheme, was itself misled by FGG, which had "trumpeted" to the SEC "their extensive due diligence of Madoff." The auditors PricewaterhouseCoopers LLP and the Fund custodians/administrators (the Citco entities) – who are defendants here – are responsible as well for fraud and gross violations of express duties to Plaintiffs by confirming the existence of billions of dollars in assets year after year, when no such assets existed.

Plaintiffs, in their continuing investigation of their claims, have learned that certain of the FGG Defendants had actual knowledge of Madoff's gross misrepresentations with respect to the "Split-Strike Conversion" strategy which he claimed to use to generate investor profits. For

example, Plaintiffs have interviewed a former consultant to FGG who has verified that on multiple occasions dating back to the mid-1990s, he informed FGG principals that Madoff was reporting that he had made "excess profit" option trades unrelated to the "split-strike" strategy, which inflated the Funds' purported profits by millions of dollars.[3] Because the "excess profit" trades were too large and consistently profitable to be believable, this witness urged FGG principals to investigate the trades with Madoff, including the identity of the counter-parties. Yet rather than undertaking meaningful investigation or due diligence concerning this information, the Defendants continued their pattern of misrepresenting their own knowledge and due diligence, while recklessly ignoring red flags, when even minimal investigation would have revealed Madoff's fraud and avoided Plaintiffs' massive losses.

The FGG Defendants' motions to dismiss are based largely on legal authorities which developed in contexts removed from what is admittedly the largest financial fraud by far in history. When Defendants' conduct is viewed as a whole in the context of Madoff's scheme, it is clear that Defendants have failed to provide legal justification to escape liability for their blatant misconduct:

First, Plaintiffs have standing to bring these claims because they were the direct recipients of the misrepresentations and omissions by FGG Defendants that led them to invest and hold money in the Funds. These representations were not made to the Funds, but to the investors, and are classic direct claims for intentional and negligent misrepresentations under federal and state law. Moreover, plaintiffs' losses are not merely "reflective" of the losses of the

[3] *See* Declaration of Robert Finkel ("Finkel Decl.") ¶¶ 18-19. Because Plaintiffs identified this confidential witness after filing the SCAC, we do not cite his testimony here to support the sufficiency of the SCAC, which we believe is entirely adequate as it stands. However, this and certain other recently obtained evidence further confirm the basis for liability alleged in the SCAC. In addition, the extraordinary scope and size of the Madoff fraud and related actions such as this one have made lengthy and ongoing investigations inevitable. *See* Point VIII below, requesting leave to amend if the SCAC were deemed insufficient.

Funds, which are subject to netting and even potential "clawback" claims by Madoff's bankruptcy trustee, based on billions of dollars received by the Funds from Madoff in the form of redemptions.

Second, the FGG defendants assured investors that the monies entrusted to them were being placed in real investments, based on a proven track record of profitability, and assured plaintiffs of FGG's diligence in protecting those investments. These statements about FGG's actions and about the Funds that FGG managed – not about Madoff's operations – were either knowingly false or made with extraordinary recklessness. If these misrepresentations and omissions do not state a case under the Securities Exchange Act of 1934, then that statute is virtually a dead-letter, and fund managers will have open season to say anything they want to raise money.

Third, separate from federal claims, defendants' actions constitute common law fraud, negligent misrepresentation, breach of fiduciary duty and gross negligence.[4]

Fourth, Plaintiffs' contract-based claims properly seek recovery for money that the FGG Defendants paid themselves on the false basis that the FGG Funds actually made large profits, when in fact the Madoff investments were illusory. Similarly, the contracts with fund managers and advisors were clearly for the benefit of the investors, giving rise to third-party beneficiary claims.

Fifth, Plaintiffs' claims are not preempted by either the Martin Act or the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). The most recent and better reasoned

[4] In the event the Court were to find that foreign law applies to any of the common law claims asserted, Plaintiffs have submitted Affidavits from Robert Miles, Q.C. (expert on U.K., British Virgin Islands ("BVI") and Bermuda law), Lewis Hunte, Q.C. (expert on BVI law) and Mark A. C. Diel (expert on Bermuda law), refuting and rebutting many of the conclusions reached by the foreign law experts proffered by Defendants and demonstrating that Plaintiffs have standing to bring the claims asserted in the SCAC and colorable claims in the BVI and Bermuda under many of the same or analogous legal theories as available under New York law.

New York decisions recognize that the Martin Act only preempts private claims that allege violations of the Act itself or its implementing regulations. And SLUSA cannot plausibly be read as intended by Congress to preempt claims arising from investments in off-shore funds not regulated by the SEC.

Sixth, because the Fairfield Greenwich Group repeatedly held itself out as a partnership to investors, and internally managed itself as such, it is liable to plaintiffs on that basis.

Seventh, the exculpatory provisions in investment management agreements do not – and lawfully, could not – shield the FGG Defendants from liability for their grossly negligent and fraudulent actions.

Finally, the FGG Defendants assert they should not be held to answer for punitive damages. If Plaintiffs ultimately prove that FGG Defendants recklessly raised billions of dollars from investors around the world without any concern for the truth or falsity of their statements, and without doing anything remotely approaching the actions they said they would take to protect investors, it is hard to imagine a fraud case more deserving of punitive damages.

ARGUMENT

I. THE SCAC PROPERLY ALLEGES EXCHANGE ACT FRAUD CLAIMS

The applicable legal standard for evaluating securities fraud claims is clear. To state a claim under Section 10(b) and Rule 10b-5 of the Exchange Act, a plaintiff must allege with particularity facts sufficient to show that a defendant: (1) in connection with the purchase or sale of securities; (2) made a materially false statement or omitted a material fact; (3) with scienter; and (4) the plaintiff's reliance on defendant's action (5) caused injury to the plaintiff. *ECA v. JP Morgan Chase Co.*, 553 F.3d 187, 197 (2d Cir. 2009). The SCAC pleads every element with respect to each of these defendants with particularity. These claims should be sustained.

A. The SCAC Properly Alleges Prima Facie Fraud Claims

From 1990 up to and until the arrest of Bernard Madoff in December 2008, the Fairfield Fraud Claim Defendants[5] marketed and sold interests in the Funds with offering materials (PPMs) that contained materially false and misleading representations and material omissions. As alleged in the SCAC, those misrepresentations induced Plaintiffs to invest in the Funds and ultimately caused them to suffer substantial economic damages. SCAC ¶ 181.

The SCAC alleges with particularity that during the Class Period the FFC Defendants made materially false and misleading statements to potential investors concerning: (1) the Funds' investment strategy and performance record; (2) the due diligence undertaken in hiring investment managers (including Madoff); (3) the post-retention "monitoring" of Madoff; and (4) Madoff's multiple roles at the Funds and the inherent risks created by not having any independent "check" on his multiple and conflicting activities.

With respect to each of these categories, as the SCAC alleges, the FFC Defendants made affirmative representations that were material to investors' decisions to invest. Moreover, as the SCAC also alleges, the FFC Defendants knew at the time they made the representations that they were false. At a minimum, they made these claims with a reckless disregard for the truth. Accordingly, the SCAC has more than met the burden of stating a securities fraud claim.

1. False Statements Concerning Investment Strategies and Results

The SCAC specifically alleges that the FFC Defendants made false statements about the Funds' investment strategy and performance history.[6] The false statements are described in

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[5] The Exchange Act claims are brought against eleven "Fairfield Fraud Claim Defendants" (hereinafter "FFC Defendants"), who are FGG, FGL, FGBL, FGA, FRS, and Messrs. Noel, Tucker, Piedrahita, Vijayvergiya, Lipton and McKeefry. SCAC ¶ 151.

[6] The FFC Defendants cannot refute the SCAC's well-pled allegations that demonstrate the falsity of their statements. Defendants, instead, strain to recharacterize the SCAC as alleging that Defendants only *promised* to invest the assets of the Funds with an investment manager who employed the split-strike

specific terms. They include misrepresentations about the Funds' trading strategy (the so-called "Split-Strike Conversion", the mechanics of the supposed strategy, and the Funds' "track record":

> The Placement Memoranda issued by the Fairfield Defendants consistently described the investment strategy of the Funds as seeking to obtain capital appreciation of its assets principally through a "Split-Strike conversion" strategy. SCAC ¶ 184.
>
> The Placement Memoranda stated that: "The establishment of a typical position entails (i) the purchase of a group or basket of equity securities that are intended to highly correlate to the S&P 100 Index, (ii) the sale of out-of-the-money S&P 100 Index call options in an equivalent contract value dollar amount to the basket of equity securities, and (iii) the purchase of an equivalent number of out-of-the-money S&P 100 Index put options." SCAC ¶ 184.
>
> The Fairfield Defendants uniformly touted – in Placement Memoranda and other uniform sales materials – the Funds' historical track record of profitability. They "set[] forth . . . the prior trading results" of the Funds, and provided a table representing a rate of return that was positive in virtually all prior months of the Fund's operation and showed substantial, consistent annualized rates of return for the Funds. For example, the FS PPM of October 1, 2004 contained four single-spaced pages of month-by-month "performance" for the 13-year plus time period from December 1990 through December 2003. SCAC ¶ 187.

Moreover, the SCAC includes specific allegations describing in what particular respects those statements were false:

> These representations of the Funds' historical returns were false. Based upon government investigations to date, Madoff did not make any securities transactions in the thirteen years prior to his arrest. There were thus no profitable months for the Funds, because their assets were not invested. SCAC ¶ 188.

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conversion strategy, and to conduct due diligence into, monitor, and verify the investments made by them. From this false premise, Defendants argue that a securities fraud claim cannot be based upon prospective statements, that is, promises. FG Br. at 52-53 (citing *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 105-06 (2d Cir. 2007)). *ATSI* is distinguishable because it involved a promise to do something in a securities transaction, not a misstatement of fact in an offering document. *Id.* at 105. The Second Circuit found that the plaintiff had failed to allege facts showing that "when the promise was made, the defendant secretly intended not to perform or knew that he could not perform." *Id.* (citation omitted). Likewise, *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993), is distinguishable because it involved the failure to perform promises made in connection with various employment contracts. Here, of course, the SCAC alleges that the Defendants were not performing at the very time they made the statements at issue. The SCAC does not allege mere promises, but rather material misstatements made to potential investors about what the FFC Defendants purportedly were doing on behalf of investors.

> The Fairfield Defendants failed to disclose to Plaintiffs the material fact that the historical returns were based solely on information provided by Madoff, and that they had failed to verify independently any of the returns they represented the Funds had earned over the years. SCAC ¶ 189.

In addition, the SCAC contains more than four pages of highly detailed allegations of specific misrepresentations concerning the Funds' performance provided by the FFC Defendants to Fund investors. SCAC ¶¶ 190–192.[7]

These representations are demonstrably false. The specific allegations are drawn from written statements made and published by Defendants with the intent that they be distributed to and relied upon by investors and prospective investors. Yet at the time the FFC Defendants issued these statements, they knew that they had never independently verified the existence or results of Madoff's "Split-Strike" strategy. *See, e.g.*, SCAC ¶¶ 184-186.[8]

In short, the FFC Defendants knew they had no basis for the statements both because they had made no effort to independently verify the information, and, because they had information that directly contradicted their representations.[9] SCAC ¶¶ 182, 185-86, 207-23. These

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[7] During the Class Period the FFC Defendants published the Funds' performance record in other uniform sales literature and monthly and semi-annual reports, which were distributed to investors. The reports contained detailed performance "data" for the Funds, all of which was false. For example, Defendants' August 2008 Monthly Strategy Review stated in part: "Fairfield Sentry Limited . . . returned 0.71% net in August 2008 and has returned 4.05% year-to-date. The S&P 100 Index advanced 1.44% during the month and has declined 12.36% year-to-date." SCAC ¶ 191(e). The September Review assured investors that "Fairfield Sentry Limited . . . returned +0.50% net in September 2008 and has returned +4.75% net year-to-date. The S&P 100 Index declined 7.60% during the month and has declined 19.02% during the year." SCAC ¶ 191(f).

[8] Indeed, evidence developed by Plaintiffs' counsel after filing of the SCAC, *see* Finkel Decl. ¶¶ 17-18, provides confirmation of the SCAC's allegations that Defendants had no knowledge of Madoff's actual operations. FFC Defendants knew that millions of dollars of Madoff's reported "profits" were likely derived from fabricated options trading.

[9] As discussed below, the assertion of these "facts" by the FFC Defendants in the face of contrary knowledge satisfies the "scienter" element of a well-pleaded complaint.

allegations clearly make out a securities fraud claim.[10]

2. False Statements Concerning Due Diligence in Hiring Madoff as Investment Manager

The SCAC's allegations of misrepresentations by the FFC Defendants in the Madoff hiring process are also specific and clear:

> The Fairfield Defendants represented that transparency was a key criterion when selecting a fund manager. They stated that among the qualities they "look[ed] for in managers," were "strong risk management"; "solid investment process"; "operational procedures"; "legal compliance"; and "transparency." SCAC ¶ 201.

As the SCAC further alleges, the notion that Madoff exhibited the kind of "transparency" that the FFC Defendants assured investors they demanded was, as was well known to Defendants, simply not true. In point of fact, as alleged in the SCAC: "Madoff refused to answer even basic questions about BMIS and its operations, let alone to permit the kind of due diligence and transparency that the Fairfield Defendants represented was necessary, was being undertaken, and that they should have undertaken." SCAC ¶ 218.

The FS PPM of August 14, 2006, FGBL's Form ADV Part II (attached as Appendix A), *see* SCAC ¶ 184 (note 1),[11] is replete with misrepresentations about the "thoroughness"

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[10] Courts have found similar misstatements actionable. *See In re Ashanti Goldfields Securities Litigation*, 184 F. Supp. 2d 247, 252-55 (E.D.N.Y. 2002) (misrepresentations about a risk mitigating strategy found to "fail to disclose the true nature of the investments.") *Id.* at 253. Recently, the Fourth Circuit, in reversing the dismissal of a complaint, held that statements regarding the defendants' policies on market timing fraudulently induced investors to purchase shares in the subject funds. *In re Mutual Funds Inv. Litig.*, 566 F.3d 111, 117 (4th Cir. 2009). *See also Adams v. Hyman Lippitt, P.C.*, No. 05-72171, 2005 WL 3556196, at *7 (E.D. Mich. Dec. 29, 2005) (statements about nature and performance of investment actionable under 10(b)).

[11] The PPMs and their attachments are properly considered in determining the sufficiency of the pleadings, a point which Defendants concede in their Motions to Dismiss. See Declaration of Michael Thorne, Esq. ("Thorne Decl."), submitted by FFC Defendants with the Motion to Dismiss the SCAC at paragraph 23: "All of the documents attached hereto [a reference to multiple FFC Defendant offering documents attached to Thorne's declaration], except the SEC Report referenced in paragraph 21 above, were submitted with or referred to by Plaintiffs in pleadings in this action." *See In re Bayou Hedge Fund Litigation*, 534 F. Supp 2d 405, 413 (S.D.N.Y. 2007), aff'd, *South Cherry St., LLC v. Hennesse Group LLC*, 573 F.3d 98 (2d Cir. 2009) ("In deciding a motion to dismiss, this court may consider the full text of

undertaken in the selection process:

> Working with one of its affiliates (Fairfield Greenwich Advisors LLC, SEC registrant 80162504), FGBL conducts a detailed manager selection and due diligence process, analyzing such important issues as liquidity management, market and credit risks, management quality (which includes on-site visit(s), background, and reference checks), and operational, compliance, and regulatory risks. At the conclusion of the manager selection process, allocation of assets from the Offshore Fund to a successful hedge fund manager (which may be managed by an affiliate of FGBL) candidate will be determined based on a qualitative and quantitative analysis of each manager's potential for long-term risk-adjusted performance, relationship with other manager's previously seeded, and expected contribution to the targeted risk return profile.

The SCAC alleges the great lengths the FFC Defendants went to in order to create the impression of an exhaustive vetting process of Madoff:

> [The Defendants] further claimed they verified a potential manager's "portfolio analysis," "financial statements," "back office procedures," and "regulatory/legal procedures" before selecting a manager. (*Id.*) They also represented that their due diligence process involved *"check[ing] for a 'reputable' auditor,"* and an "understand[ing] . . . of explanation of valuation methods used [and] trade execution process. (*Id.* at 14-15)" (emphasis added). SCAC ¶ 201.

The SCAC exposes the fallacy of these misrepresentations as well. As an obvious example, the *"check[ing] for a 'reputable' auditor"* clearly did not occur. As the SCAC points out, when the FFC Defendants sought "to find out information about F&H . . . [t]hey discovered that F&H was operating out of a strip mall in New City, New York, and that '[i]t appears that Friehling is the only employee.'" SCAC ¶ 225. In other words, the SCAC alleges a clear misstatement about the quality of Madoff's auditor made by the FFC Defendants even though they knew it was not true.

As the SCAC alleges, misrepresentations made to potential investors about the manager selection process were materially false and caused harm to the plaintiffs. If the FFC Defendants had done the diligence they claimed to have done, they would not have retained Madoff as the

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documents that are quoted in the complaint or documents that the plaintiff either possessed or knew about and relied upon in bringing the suit.")

Funds' investment manager. *Nathel v. Siegal*, 592 F. Supp. 2d 452, 465 (S.D.N.Y. 2008) (finding falsity because the defendants allegedly "did not investigate the tax deductions or the wells and knew virtually nothing of the investment. . ."). The allegations as to Defendants' misrepresentations regarding the hiring process of the Funds' investment managers (including Madoff) are well pleaded.

3. False Statements Concerning Ongoing "Monitoring" of Madoff

As with the Funds' strategy, performance history, and the investment manager hiring process, the SCAC contains specific allegations of materially misleading statements made by the FFC Defendants about their purported monitoring of Madoff's activities. First, the SCAC alleges that Defendants claimed to understand and actively oversee Madoff's trading strategy.[12]

> The FFC Defendants also represented in the PPMs that they imposed "guidelines" on Fund accounts held by Madoff for implementation of the split-strike conversion strategy as well as other "Investment Restrictions":
>
> > The Split-Strike Conversion strategy is implemented by Bernard L. Madoff Investment Securities LLC ("BLM") [BMIS], a broker-dealer registered with the Securities and Exchange Commission, through accounts maintained by the Fund at that firm. The accounts are subject to certain guidelines which, among other things, impose limitations on the minimum number of stocks in the basket, the minimum market capitalization of the equities in the basket, the minimum correlation of the basket against the S&P 100 Index, and the permissible range of option strike prices [footnote omitted]. SCAC ¶ 195.

As the SCAC alleges, the FFC Defendants' supposed understanding of Madoff's trading strategy

[12] The Appendices to the PPMs, the Forms ADV filed with the SEC, contained similar materially false statements concerning the ongoing monitoring of independent investment managers such as Madoff. According to the August 2006 FS PPM, Thorne Decl. Ex. 1, Sch. F continuation sheet, Items 4.A.(5), 4.B(8), and II.A., an affiliate of the FFC Defendants was to "conduct both pre- and post investment quantitative analysis of hedge fund managers, monitor the market risk and provide quantitative analysis supporting the asset allocation decisions across the firm's multi-strategy funds." The PPM stressed the "transparency" that would be the hallmark of monitoring efforts: "An important component of the FGG product platform is *the position level transparency that we receive from all single managers . . .*" (emphasis added). Moreover, the PPM states, that monitoring is accomplished with "sophisticated quantitative measurement tools." As the FFC Defendants well knew, this was empty rhetoric, and such monitoring did not occur.

was completely contrived and was compounded by false claims about the verification that was to purportedly be undertaken with respect to individual trades:

> The Fairfield Defendants uniformly and consistently represented to existing and potential investors that they conducted thorough due diligence and strict oversight of Madoff's operations, that they independently verified his transactions, and even that they had full transparency and privileged access to Madoff. Through these statements, the Fairfield Defendants recognized the type of diligence and monitoring that they should have been conducting as to Madoff, yet they failed to perform it. SCAC ¶ 193.

In addition, as the SCAC alleges, the FFC Defendants made numerous misrepresentations about the daily checking they would conduct on Madoff:

> [The Fairfield Defendants] repeatedly represented that they conducted daily monitoring of Madoff's activities and compliance with Fund guidelines. For example, they indicated that they conducted "detailed daily compliance monitoring of portfolio activity against all risk limits" and "daily positions-based risk measurement, performance attribution and other quantitative analytics. (Fairfield Sentry Limited Standardized Responses, Dec 2008 [paragraphs] 54, 69.) They similarly represented that "portfolio holdings are reconciled daily" using "proprietary software." (Fairfield Sentry Limited Due Diligence Questionnaire, Oct. 2007, at 21.) They further represented that: "The Investment Manager monitors compliance of the SSC strategy against these risk limits and guidelines each day." (Fairfield Sentry Limited Standardized Responses, Dec. 2008, [paragraph] 77.) SCAC ¶ 196.

> The Fairfield Defendants represented in the PPMs that defendant FGBL (the Funds' investment manager/general partner) was "responsible for the management of the Fund's investment activities, the selection of the Fund's investments, monitoring its investments and maintaining the relationship between the Fund and its escrow agent, custodian, administrator, registrar and transfer agent." SCAC ¶ 194.

The SCAC further alleges that the FFC Defendants represented that "regular on-site visits [of Madoff's firm] are conducted by a number of senior members of FGG's legal, operations, and risk teams" (SCAC ¶ 197) and that they maintained "deep, ongoing joint venture relationships" with their fund managers and would review on an ongoing basis "audited financials and auditor's management letter comments"; "accounting controls: from trade execution; to trade capture; to trade reconciliation with the Street, administrator, and fund; to

fund's books and records"; "bank reconciliations for irregular or outstanding items"; and "broker reconciliations to ensure completeness and existence of all securities." SCAC ¶ 202.

These representations were false. The FFC Defendants failed to conduct any meaningful monitoring of Madoff, let alone (as they represented above) the thorough monitoring of him as an investment manager in order to assess the manager's and the fund's performance, ensure that the manager adhered to fund objectives and guidelines, monitor cash flow, limit the risk to investors, and track the Fund assets. However, they did none of these. Indeed, not only did they not perform these rudimentary checks, they apparently misled the SEC about them. *See* Finkel Decl. ¶ 10 ("the enforcement team was assured by Fairfield Greenwich that it conducted regular audits of Madoff's operations and that it had confirmed that Madoff had maintained custody of the funds entrusted to him.")[13] They knew full well that such checks did not go on. As the SCAC alleges, Defendant Tucker never toured Madoff's office where the "strategy" was supposedly executed and did not know of anyone who did. SCAC ¶ 214. Providing these false assurances to investors was at the least reckless, and at worst, an intentional effort to defraud. As the SCAC alleges, had Defendants done what they claimed, they would not have kept Madoff on as the Funds' investment manager. These allegations – the supposed "monitoring" of Madoff that allowed the fraud to flourish – are properly pleaded.

4. Material Omission in Disclosure of Madoff's Multiple Conflicting Roles and the Associated Risks

The SCAC specifically alleges that during the Class Period the FFC Defendants did not disclose the risk of Madoff holding multiple roles of investment manager, clearing firm,

[13] The referenced material in the Finkel Declaration is part of the record made public by the SEC in connection with publication of a report by its Inspector General into the Madoff fraud. The OIG Report was submitted by the FGG Defendants in support of their motions to dismiss. FG Br. at 5. If the OIG Report is considered by the Court, *see, e.g., In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 402, 408 (S.D.N.Y. 2005), it is appropriate to consider also Finkel Exhibits 3 and 4 which confirm allegations in SCAC ¶ 234 concerning FGG's assistance to Madoff in thwarting the SEC investigation.

executing broker and custodian. *See, e.g.*, SCAC ¶ 212: "The Fairfield Defendants acquiesced to the unusual arrangement by which BMIS served as both the sub-custodian or custodian of Fund assets and the executing broker, as well as the investment manager."

Over the Class Period the description of Madoff's activities was materially deficient. For example, the FS PPM for October 1, 2004 at 14-15 (Thorne Decl. Ex. 13), stated that BMIS was a sub-custodian for the Funds with approximately 95% of the Funds' assets under custody. The PPM did *not* disclose that Madoff was also the sole investment manager and executing broker for the SSC strategy. By August 2006 the PPMs contained a fuller description of Madoff, but still did not disclose his role as investment manager. The PPM notes that BMIS is a broker-dealer, and the language conveys a functionary role: BMIS was the "execution agent," "implementing" the SSC strategy through "accounts maintained by the Fund" at Madoff. FS PPM-8/14/06, at 9-10, 16 (Thorne Decl. Ex. 1). In the August 2006 GS COM, Thorne Decl. Ex. 3, the reference to Madoff under "Management Fee and Expenses" describes his role as executing broker and clearing firm but *not* his role as investment manager: "The General Partner does not receive any compensation, directly or indirectly, with respect to the *brokerage and clearance charges* incurred in connection with the Partnership's account at BLM" (italics added). *Id.* at 20.

Portions of the offering materials devoted specifically to discussion of investment *risk* also failed to disclose Madoff's multiple roles. "Risk Factors" subsections[14] that appear throughout the 2004 PPM – as well as a separate section for "Potential Conflicts of Interest" – omit to mention Madoff at all, let alone the conflict of interest and attendant risk created by him serving as custodian, executing broker, and investment manager. FS PPM for October 1, 2004 at

[14] Numerous sections throughout the document contain a separate subsection for "Risk Factors", including sections on "Dependence Upon Principals and Key Employees of the Manager," "Conflicts of Interest," "Possibility of Misappropriation of Assets, and "Sole Proprietor Non-SSC Investment Managers." Similar sections appear in the 2006 PPM.

16-17, 20-21 (Thorne Decl. Ex. 13).

The August 2006 FS PPM, with nearly identical risk subsections as its 2004 counterpart, contains fleeting mention of Madoff, FS PPM for August 14, 2006, at 17-19, 22-23. (Thorne Decl. Ex. 1), and once again does not clarify his role as Fund advisor. Indeed, a section on key personnel seems to expressly distinguish Madoff from the Fund manager: "the services of the Investment Manager's [FGBL] principals and key employees and [Madoff] are essential to the continued operation of the Fund." FS PPM for August 14, 2006, at 18. An earlier reference in the PPM (at 16) reiterates Madoff's role as "executing broker." There is no statement that Madoff is the investment manager and custodian and no disclosure of the risks created by his multiple roles.

The first arguably adequate disclosure of Madoff's role at the Funds did not appear until December 2008, just days before the Ponzi scheme publicly collapsed. The FFC Defendants issued a new Fairfield Sigma PPM on December 1, 2008, that for the first time expressly identified Madoff as the Fund "manager." Thorne Decl. Ex. 2, FS PPM 12/1/08 at 20 no. 4. A new subsection to the "Risk Factor" section of the PPM entitled "Non Diversification" disclosed that "[s]ubstantially all of the Fund's assets . . . will be invested in accounts *managed* by" BMIS (emphasis added). *Id.* Even at that late date, however, the December 2008 PPM still failed to provide adequate disclosure of the extraordinary risk of having so many functions concentrated in one individual.[15]

[15] In addition to the inadequate disclosures about multiple functions, FFC Defendants exhibited over the years an unusual ambivalence about mentioning Madoff by name, which is a further indicia of scienter. Notably, Madoff's identity as investment manager was disclosed to potential investors in PPMs that were effective through the end of 2002, after which those references were expunged. Madoff did not appear in offering materials again until 2006. Finkel Decl. ¶ 13, and Ex. 4 at 12419-23. The lengths that the FFC Defendants went to disguise Madoff's affiliation with the Funds is further evidence of scienter. *See In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 72 (2d Cir. 2001) (pre-class period data is relevant when evaluating scienter allegations).

On this issue as well, the disclosures by the FFC Defendants were clearly at odds with the facts they had before them. As described in more detail below, the FFC Defendants exchanged emails in the fall of 2008 indicating that even at that late date they had virtually no access to Madoff and did not know how he functioned. *See* I. B. 6, below. Nonetheless, they failed to disclose their gross ignorance about these critical aspects of Madoff's operations (which necessarily had to exist in all years), and failed to apprise Fund investors of the risks and vulnerabilities of the Madoff arrangement. The allegations on this topic are well pleaded and, as described immediately below, create a strong inference of scienter.

B. The SCAC Properly Alleges Scienter

1. Applicable Standards

The PSLRA requires that plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Under Section 10(b) and Rule 10b-5, the requisite state of mind is an intent "to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)), or recklessness. *ECA*, 553 F.3d at 198; *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 194 (2d Cir. 2008) ("*Teamsters Local*"); *Novak v. Kasaks*, 216 F.3d 300, 308-09 (2d Cir. 2000). Recklessness is "'at the least, . . . an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *ECA*, 553 F.3d at 198.

To determine whether a strong inference of scienter exists, the court must "accept all factual allegations in the complaint as true" and consider all of the allegations taken together. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (*Tellabs* I), 551 U.S. 308, 324 (2007). An inference of scienter need not be irrefutable, but should be considered "strong" when it is at least as likely

as any other inference.[16] *Tellabs I*, 551 U.S. at 324. In other words, a "tie . . . goes to the plaintiff." *Akerman v. Arotech Corp.*, 608 F. Supp. 2d 372, 382 (E.D.N.Y. 2009); *In re Amaranth Natural Gas Commodities Litig.*, 587 F. Supp. 2d 513, 543 n.199 (S.D.N.Y. 2008). The Court should only consider opposing inferences that are plausible and "rationally drawn from the facts alleged," not the facts as a defendant would like them to be. *Tellabs I*, 551 U.S. at 314; *ECA*, 553 F.3d at 198.[17]

To satisfy the scienter requirement, a plaintiff "may (1) allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness, or (2) allege facts to show that defendants had both motive and opportunity to commit fraud."[18] *Rombach v. Chang*, 355 F.3d 164, 176 (2d Cir. 2004); *ECA*, 553 F.3d at 198; *Ganino v. Citizens Util. Co.*, 228 F.3d 154, 168-69 (2d Cir. 2000).

The Second Circuit has identified four types of allegations that will suffice to allege scienter. In addition to allegations that the defendants "(1) benefited in a concrete and personal way from the purported fraud," or "(2) engaged in deliberately illegal behavior," they include allegations that the defendant "(3) knew facts or had access to information suggesting that their public statements were not accurate," or "(4) failed to check information they had a duty to

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[16] "The Supreme Court's reasoning in *Tellabs* permits a series of less precise allegations to be read together to meet the PSLRA requirement . . . .Vague or ambiguous allegations are now properly considered as a part of a holistic review when considering whether the complaint raises a strong inference of scienter." *S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008).

[17] Under *Tellabs I*, the defendant has the burden to show that the Complaint's allegations give rise to an inference of innocent behavior that is stronger than the inference of recklessness. *Akerman*, 608 F. Supp. 2d at 382.

[18] Conscious misbehavior "encompasses deliberate illegal behavior." *Novak*, 216 F.3d at 308. Motive entails "concrete benefits" that could be realized by the defendant's false statements and wrongful nondisclosures. *In re WorldCom, Inc., Sec. Litig.*, 294 F. Supp. 2d 392, 399-400, 412 (S.D.N.Y. 2003). Allegations of defendants' motive may not be considered in isolation; rather, the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint. *Tellabs I*, 551 U.S. at 325. The FFC Defendants' motive was to collect astronomical fees, and they do not contest opportunity to commit fraud.

monitor." *ECA*, 553 F.3d at 199 (*quoting Novak*, 216 F.3d at 311; *Teamsters Local*, 531 F.3d at 194); *In re Novagold Res. Inc. Sec. Litig.*, 629 F. Supp. 2d 272, 297 (S.D.N.Y. 2009); *In re Worldcom, Inc. Sec. Litig.*, 294 F. Supp. 2d at 392, 412 (S.D.N.Y. 2003).

2. Defendants Had Information Contradicting Their Misstatements in the PPMs

The SCAC, as indicated, details numerous instances where the FFC defendants had information that directly contradicted their statements in the PPM. Demonstrating that a defendant "had access to information suggesting that their public statements were not accurate" suffices to plead scienter. *E.g., Novak*, 216 F. 3d at 311. *See, e.g., Cornwell v. Credit Suisse Group*, 2010 WL 537593 (S.D.N.Y. Feb. 11, 2010); *In re Marsh & Mclennan Companies, Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 480-81 (S.D.N.Y. 2006). Courts in other circuits are in accord. *E.g., Makor Issues & Rights, Ltd. v. Tellabs Inc. (Tellabs II)*, 513 F.3d 702, 704 (7th Cir. 2008) ("When the facts known to a person place him on notice of a risk, he cannot ignore the facts and plead ignorance of the risk.").

As the SCAC alleges, the FFC Defendants had substantial information that contradicted the trading strategy and performance they reported to existing and prospective investors. The FFC Defendants knew that Madoff refused to give them any information whatever about his trading strategy and that credible sources questioned how it was possible to achieve such results. Yet defendants hid their ignorance from investors, instead falsely assuring investors that they were informed of and confident in Madoff's trading strategy. These materially misleading disclosures provide a strong inference of scienter.[19]

[19] Subsequent to filing the SCAC, Plaintiffs' counsel learned from a confidential witness who had been hired by FGG to analyze Madoff's reported trades that he informed FGG several times a year from the mid-1990's onward that Madoff had reported suspicious "excess profit" option trades unrelated to the purported split-strike strategy that produced many millions of dollars in reported profits. The witness finally became so concerned about these trades that he insisted Defendants investigate them, which they

The allegations of contradictory information are also glaring with respect to the hiring and monitoring of Madoff. For example, in connection with the selection of the investment manager, the FFC Defendants set forth in the PPM and related materials extensive criteria they claimed to "look for in managers" but which, in practice, they never acted on. To conduct the meticulous search that FGG's offering materials represented had been done, Defendants would have had to have access to information from the prospective manager. The FFC Defendants would have had to obtain information about the "Split-Strike Conversion" strategy, portfolio composition and analysis, and how the investment strategy was implemented. The inference is overwhelming that if FFC Defendants had actually done the work they said they performed, they would have discovered Madoff's scheme. Instead, Defendants claimed that they had undertaken a careful selection process when they knew that no such thing had occurred. The SCAC's allegations regarding this failure by the Fairfield Defendants create an inference of scienter.

Moreover, once the manager was selected, the FFC Defendants claimed they were reviewing Fund holdings and communicating with custodians and/or trustees to monitor cash flow and fund compliance. In short, they represented that they had and would continue to monitor the manager.[20] SCAC ¶¶ 194-204. However, contrary to the assurances of a robust monitoring of Madoff's activities, the Defendants knew full well that they had virtually no

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had apparently never done. *See* Finkel Decl. ¶¶ 14-20, and n. 3 *supra*. This evidence further confirms Defendants' utter lack of any effort to verify whether there was any legitimate explanation for Madoff's too-good-to-be-true results. Yet they continued for years to report those results to Plaintiffs and pay themselves handsomely based on those numbers.

[20] An appropriate review and monitoring, consistent with what the Fairfield Defendants represented, would have included at a minimum a review of the size and structure of the manager's organization; ownership of the manager's organization; registrations and regulation of the manager (including Form ADV, if applicable); descriptions and biographies of the portfolio managers, and compensation and incentive arrangements for key employees; the back office operations, including the paper flow (computerized or otherwise) and procedures implemented for mark to market pricing and fund accounting; and the professional relationships of the manager, *e.g.*, custodian/broker dealer, administrator, auditor/accounting firm, and legal counsel. SCAC ¶¶ 193-204.

access whatever. The FFC Defendants did not have access to Madoff's accounts, so they could not possibly confirm that Fund investment guidelines were being followed. In addition, as alleged in the SCAC, Madoff did not allow them to examine trading records that would permit verification that transactions were even made, much less the transaction price or account value. SCAC ¶¶ 210-12.

The mental state of the FFC Defendants is revealed by their frantic emails in the Fall of 2008 concerning what they euphemistically called their "gaps" in knowledge of Madoff's operations. Each of the six individual FFC Defendants was a party to these emails. SCAC ¶¶ 206-09.

A strong inference, if not the only reasonable one, from these allegations is that the FFC Defendants were privy to information that flatly contradicted many statements they made in the PPMs. *See, e.g., Nathel*, 592 F. Supp. 2d at 465 (scienter shown by alleged misrepresentations that the defendants' "access to . . . documents that contradicted their public statements [and that defendant] . . . . Josephson did not investigate the tax deductions or the wells and knew virtually nothing of the investment . . ."); *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC*, 376 F. Supp. 2d 385, 404 (S.D.N.Y. 2005). With respect to Fund performance, the hiring and monitoring of Madoff, and the risks created by his roles, Defendants were in possession of information that contradicted their misstatements to potential investors. These allegations create a strong inference of scienter.[21]

[21] Although the FFC Defendants denied liability, the plausibility of the SCAC in alleging that the FFC Defendants failed to perform the due diligence, which the PPMs stated they were performing, is supported by Defendants' settlement with the Securities Division of the Commonwealth of Massachusetts. Finkel Decl. ¶ 6, Ex. 2. The Administrative Complaint there was "based on a profound disparity between the due diligence Fairfield represented to its investors that it would conduct with respect to [BMIS] and the due diligence it actually conducted, as well as misrepresentations to investors in its Sentry funds about Fairfield's degree of knowledge and comfort with respect to Madoff's operations." As part of their Consent Order with the Commonwealth (appended as Finkel Decl., Ex. 1),