

Exhibit 2

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re: BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Debtor,	Adv. Pro. No. 08-01789 (BRL) SIPA LIQUIDATION (Substantively Consolidated) Adv. Pro. No. 10-5287 (BRL)
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, Plaintiff, v. SAUL B. KATZ, et al., Defendants.	11-CV-03605 (JSR) HBP)

REBUTTAL EXPERT REPORT OF
DR. STEVE POMERANTZ

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Attorneys for Irving H. Picard, Trustee for the Substantively Consolidated SIPA Liquidation of Bernard L. Madoff Investment Securities LLC and Bernard L. Madoff

TABLE OF CONTENTS

1. This report is offered pursuant to Federal Rule of Civil Procedure 26(a)(2) and is authored by Dr. Steve Pomerantz, president of Steve Pomerantz LLC, an economic and financial consulting firm located in Princeton, New Jersey.[1] I submitted an Initial Report in this matter on November 22, 2011 ("Pomerantz Report").

I. Assignment Scope and Methodology

2. I have been retained through D&P by Baker & Hostetler LLP ("Baker"), counsel for Irving H. Picard, Trustee ("Trustee") for the Substantively Consolidated SIPA Liquidation of Bernard L. Madoff Investment Securities ("BLMIS") and Bernard L. Madoff ("Madoff"). Herein I respond to the Expert Report of Mr. John Maine ("Maine") ("Maine Report") filed on November 22, 2011 in the above-captioned proceeding. In particular, I respond to: (i) Maine's characterization of, and errors with respect to his conclusions concerning, trade confirmations, account statements and other documentation received by Sterling, (ii) Maine's characterization of, and erroneous assumptions concerning, the investment management industry, and (iii) Maine's apparent failure to adequately consider case-specific information when formulating his opinions.

II. Summary of Conclusions

3. Based on my review of the Maine Report, my more than 25 years of professional experience, my independent review of documents and testimony in the record to date, my own independent analysis, as well as customs and practices of the investment management industry, my opinions in response to the Maine Report are as follows:

   a) The trade confirmations, customer statements and portfolio management reports received by Sterling were non-standard, atypical, and reflected significant (and plain) deviations from typical statements;

[1] Duff & Phelps, LLC, a financial advisory and investment banking services firm ("D&P"), was retained in this matter by Irving Picard, appointed as the Trustee for the liquidation of Bernard L Madoff Investment Securities, and Steve Pomerantz, LLC was retained by D&P. Employees of D&P worked under my direction and supervision in the preparation of work supporting my opinions contained herein.

b) Sterling was not "entitled to" expect that the account statements it received were accurate simply because the statements listed investment management industry organizations;

c) High net worth and sophisticated investors like Sterling, with hundreds of millions of dollars invested, do not (and in this case did not) just "look at the bottom line" and "then file the statement away." Sterling actively monitored its returns and reviewed customer statements on a consistent basis;

d) Maine completely ignores a fundamental aspect of the investment management industry—the necessity for due diligence;

e) Maine's opinion on the use of paper statements is incorrect, and the paper statements received by Sterling were inconsistent with industry customs and practices;

f) Maine grossly misstates the use of commissions as a form of compensation for investment advisers; by only charging (theoretically) commissions instead of industry standard management and incentive fees, Madoff left hundreds of millions of dollars on the table;

g) Sterling is certainly not like "most brokerage clients." Maine ignores (among many other things) that Sterling is an active, sophisticated investor with its own hedge fund and a "high" level of "financial expertise."[2] Additionally, Sterling sits on the boards of major corporations, including financial institutions;

h) The paperwork underlying Sterling's accounts were inconsistent with Maine's characterization of Madoff's operations, Sterling's testimony regarding Madoff's operations, and how Madoff operated as an investment adviser; and

i) Madoff's fraudulent IA business was far from "normal." In addition to the exceptional consistency of investment performance, there were numerous warning signs and red flags that accumulated over Sterling's two plus decade relationship with Madoff.

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2 *See* Pomerantz Report at 10-11.

III. Madoff's Trade Confirmations and Account Statements Were Not "Entirely Standard"

4. One of Maine's principal opinions appears to be that "the confirmations and statements issued by BLMIS were *entirely standard*, and that there was no subjective basis . . . to distinguish a BLMIS brokerage account from any other brokerage account" (emphasis added).[3] I reviewed three types of account statements that were regularly delivered to Sterling during its investment relationship with Madoff: (i) trade confirmations, (ii) customer statements, and (iii) portfolio management reports. In my professional opinion, none of these documents were "entirely standard." To the contrary—each document reflected significant (and plain) deviations from typical statements of similar purpose.

5. Features of typical brokerage-related statements include, but are not limited to:[4]

   a. Account information – Name, time period, account number, broker contact information;
   b. Statement Account/Summary – Realized and unrealized gains/losses, total value of securities (both beginning and ending balance);
   c. Portfolio Detail – Information on individual asset holdings, including estimated income and yield, bond ratings and stock ticker symbols;
   d. Income Summary – Dividends and income earned by investments during the period (and/or year-to-date);
   e. Daily Activity – Detailed account activity at a transaction level; and
   f. Disclosures – Administrative and legal explanations regarding the statement or account.

6. As described in detail below, Madoff's statements deviated from this sort of typical information, and were non-standard in multiple ways.

A. Trade Confirmations

7. The first document Sterling would have received in connection with a transaction in its account would have been a trade confirmation, providing details about a purported trade

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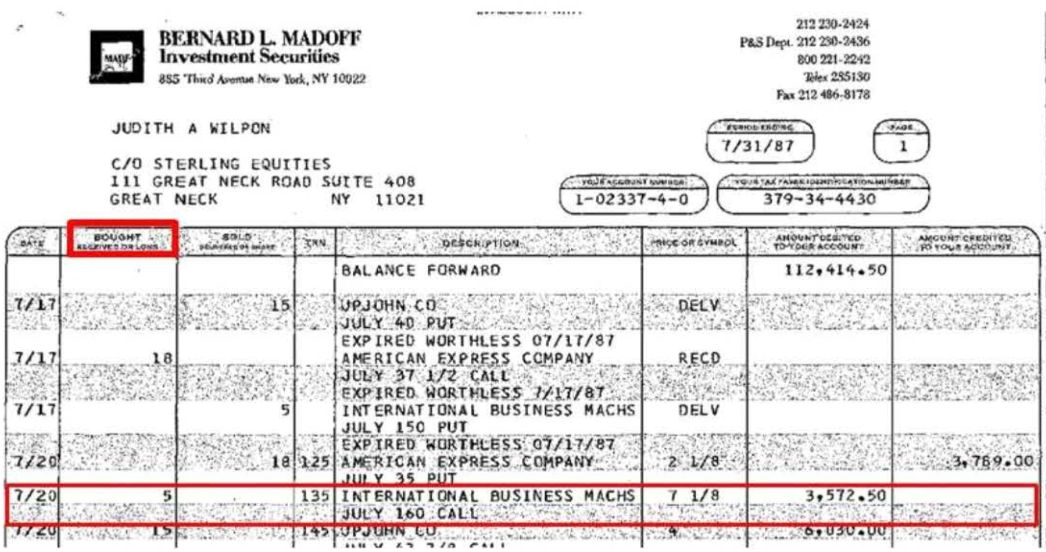
[3] Maine Report at 11.
[4] "Understanding Your Brokerage Accounts" at 2, SIFMA, SIPC, NASAA (March 7, 2007).

such as the date of the trade, the security traded, and the quantity traded. However, the trade confirmations received by Sterling were non-standard, atypical, and excluded the type of information that investors would have expected to see on trade confirmations.

8. First, the trade confirmations that Sterling received were <u>backwards</u>. That is, when Madoff purportedly bought a security for one of Sterling's BLMIS accounts, Sterling would receive a trade confirmation showing a "sale" of a security.[5] Conversely, when Madoff purportedly sold a security from one of Sterling's BLMIS accounts, Sterling would receive a trade confirmation showing a "buy" of a security. For example, in July 1987, the customer statement for account number 1-02337-4-0 reported that Madoff bought five contracts (500 shares) of IBM call options which settled on July 20, 1987 (see below—5 contracts are listed in the "BOUGHT" column).[6]

Figure 1
Customer Statement Showing BUY



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JUDITH A WILPON

C/O STERLING EQUITIES
111 GREAT NECK ROAD SUITE 408
GREAT NECK NY 11021

PERIOD ENDING: 7/31/87
PAGE: 1
YOUR ACCOUNT NUMBER: 1-02337-4-0
YOUR TAX PAYER IDENTIFICATION NUMBER: 379-34-4430

DATE	BOUGHT RECEIVED OR LONG	SOLD DELIVERED OR SHORT	TRN	DESCRIPTION	PRICE OR SYMBOL	AMOUNT DEBITED TO YOUR ACCOUNT	AMOUNT CREDITED TO YOUR ACCOUNT
				BALANCE FORWARD		112,414.50	
7/17		15		UPJOHN CO JULY 40 PUT EXPIRED WORTHLESS 07/17/87	DELV		
7/17	18			AMERICAN EXPRESS COMPANY JULY 37 1/2 CALL EXPIRED WORTHLESS 7/17/87	RECD		
7/17		5		INTERNATIONAL BUSINESS MACHS JULY 150 PUT EXPIRED WORTHLESS 07/17/87	DELV		
7/20		18	125	AMERICAN EXPRESS COMPANY JULY 35 PUT	2 1/8		3,769.00
7/20	5		135	INTERNATIONAL BUSINESS MACHS JULY 160 CALL	7 1/8	3,572.50	
7/20	15		145	UPJOHN CO	4	6,030.00	

9. However, the trade confirmation for this transaction reported a sale of the security (see

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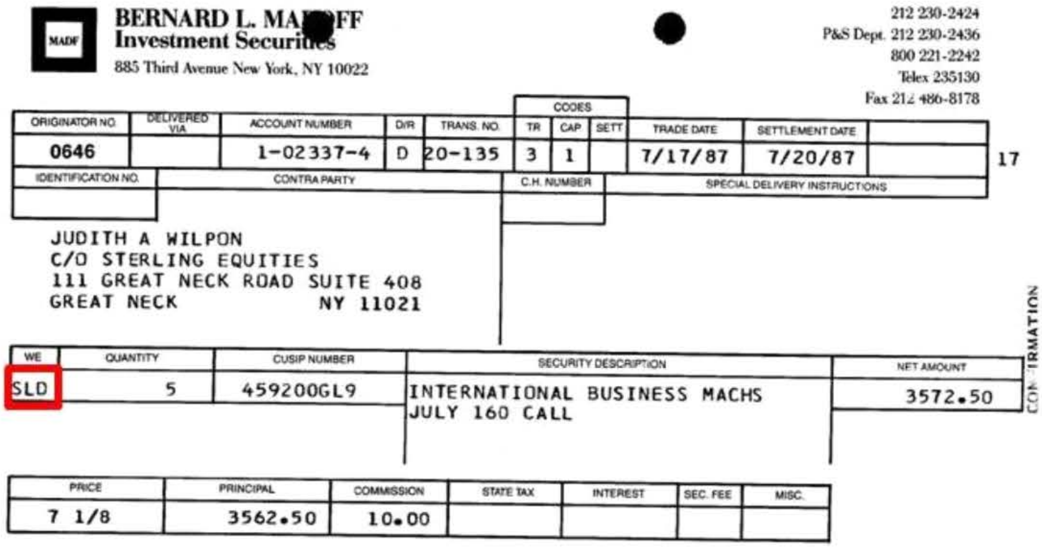
5 Cynthia Rongione Dep. 55-56, November 15, 2011.

6 Judith A. Wilpon account statement, account number 1-02337-4-0, July 31, 1987 (MWPTAP00016878-80). Each option contract reflects 100 option shares. This is just one example of the backwards trade confirmations that Sterling received. Based on my review of the documents produced by Sterling, it appears that every single trade confirmation throughout the entire life of its investments with BLMIS was backwards.

below—SLD is short for "SOLD").[7]

Figure 2
Trade Confirmation Showing SELL



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ORIGINATOR NO.	DELIVERED VIA	ACCOUNT NUMBER	D/R	TRANS. NO.	CODES TR	CODES CAP	CODES SETT	TRADE DATE	SETTLEMENT DATE	
0646		1-02337-4	D	20-135	3	1		7/17/87	7/20/87	17

IDENTIFICATION NO.	CONTRA PARTY	C.H. NUMBER	SPECIAL DELIVERY INSTRUCTIONS

JUDITH A WILPON
C/O STERLING EQUITIES
111 GREAT NECK ROAD SUITE 408
GREAT NECK NY 11021

WE	QUANTITY	CUSIP NUMBER	SECURITY DESCRIPTION	NET AMOUNT
SLD	5	459200GL9	INTERNATIONAL BUSINESS MACHS JULY 160 CALL	3572.50

PRICE	PRINCIPAL	COMMISSION	STATE TAX	INTEREST	SEC. FEE	MISC.
7 1/8	3562.50	10.00				

CONFIRMATION

10. In my 25 years of experience working with trade confirmations and account statements for myself as well as for my clients, I have never seen trade confirmations provided to clients in this manner where the trade confirmation reflects exactly the opposite of what the customer statement reflects, or the trade that was purportedly executed. Madoff's trade confirmations were non-standard in this regard.

11. Second, the equity trade confirmations that Madoff provided Sterling leave out the most basic information that is included on every trade confirmation I have ever seen: the commission for the executing broker. Commissions for equity trades are required by the Securities and Exchange Commission ("SEC") to be reported on trade confirmations.[8]

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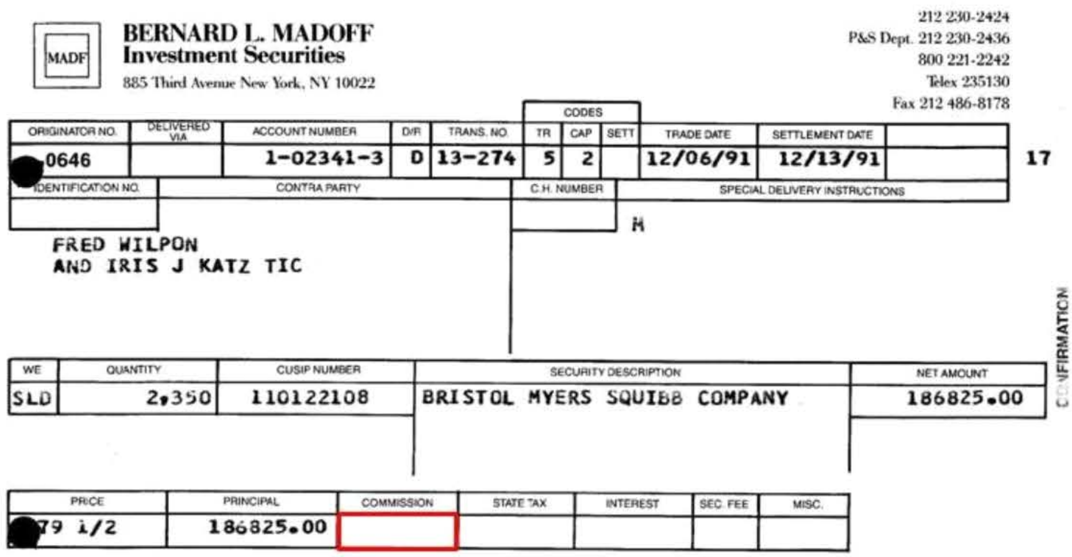
7 Trade Confirmation for Sale of IBM call options, settlement date of July 20, 1987, for account number 1-02337-4 (SE_T421985 at 2135).

8 17 CFR § 240.10b-10. Paragraph (a)(2)(i)(B) states that written notification must disclose: "The amount of any remuneration received or to be received by the broker from such customer in connection with the transaction unless remuneration paid by such customer is determined pursuant to written agreement with such customer, otherwise than on a transaction basis." This applies when the broker or dealer acts as an agent. According to the "Capacity (CAP) Code" indicated on numerous BLMIS's trade confirmations, BLMIS was acting in the capacity of an agent. *See, e.g.* Trade Confirmation for "purchase" of Digital Equipment Corp, settlement date of December 30, 1988, for account number 1-01727-3 (SE_T422406 at 412-13).

Notwithstanding Madoff's claim that he was purportedly charging $0.04 per equity trade,[9] Madoff's trade confirmations, for nearly 23 years, never reported commissions payable to BLMIS.[10] The following figure illustrates the lack of commissions on Madoff's trade confirmations—the red box highlights the area where the commission should be reported.

Figure 3
Equity Trade Confirmation Without Any Commission Fee


MADF

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ORIGINATOR NO.	DELIVERED VIA	ACCOUNT NUMBER	D/R	TRANS. NO.	CODES: TR	CAP	SETT	TRADE DATE	SETTLEMENT DATE	
0646		1-02341-3	D	13-274	5	2		12/06/91	12/13/91	

17

IDENTIFICATION NO.	CONTRA PARTY	C.H. NUMBER	SPECIAL DELIVERY INSTRUCTIONS
			H

FRED WILPON
AND IRIS J KATZ TIC

WE	QUANTITY	CUSIP NUMBER	SECURITY DESCRIPTION	NET AMOUNT
SLD	2,350	110122108	BRISTOL MYERS SQUIBB COMPANY	186825.00

CONFIRMATION

PRICE	PRINCIPAL	COMMISSION	STATE TAX	INTEREST	SEC. FEE	MISC.
79 1/2	186825.00					

12. The fact that trade confirmations were backwards and omitted standard and required information means the trade confirmations were non-standard and were unlike any other trade confirmations I have seen in the industry.

B. Customer Statements

13. Sterling received monthly customer statements from Madoff. These statements also contained several non-standard characteristics.

14. First, the statements listed the names of stocks purportedly bought and sold, but did not list the ticker symbols. It is industry custom and practice for stock ticker symbols to appear on

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9 Chachra Dep. Ex. 9 (November 29, 2005); David Basner Memo November 25, 2005 (SSMT00052064-65).

10 Trade Confirmation for "sale" of Bristol Myers Squibb Company, settlement date of December 13, 1991, for account number 1-02341-3 (SE_T422654). This is just one example of the thousands of Sterling trade confirmations that did not report commissions.

customer statements when transaction level information is included,[11] but there were no ticker symbols shown anywhere on the customer statements Sterling received from Madoff.

15. Second, Sterling's BLMIS account customer statements reported nonexistent securities. On hundreds of statements, Sterling's BLMIS accounts showed the purported purchase or sale of the Fidelity Spartan U.S. Money Market Fund (Ticker: FDLXX).[12] While this fund officially changed its name to Fidelity U.S. Money Market Fund, effective August 15, 2005,[13] Sterling's BLMIS account customer statements never reflected the name change, and continued to report the historical, incorrect name.

16. Finally, Sterling's BLMIS account customer statements reported a "Balance Forward" that was entirely inconsistent with industry customs and practices. Rather than listing the total beginning balance in the account (i.e., cash balance plus the market value of securities), Sterling's BLMIS account customer statements reported only the beginning cash position. In the example below, the ending balance in the equity account as of July 31, 1997 was $15,507.14 in cash and $337,376 in securities. However, the Balance Forward in the August 31, 1997 customer statement was only $15,507.14, reflecting only the cash balance (see below).[14]

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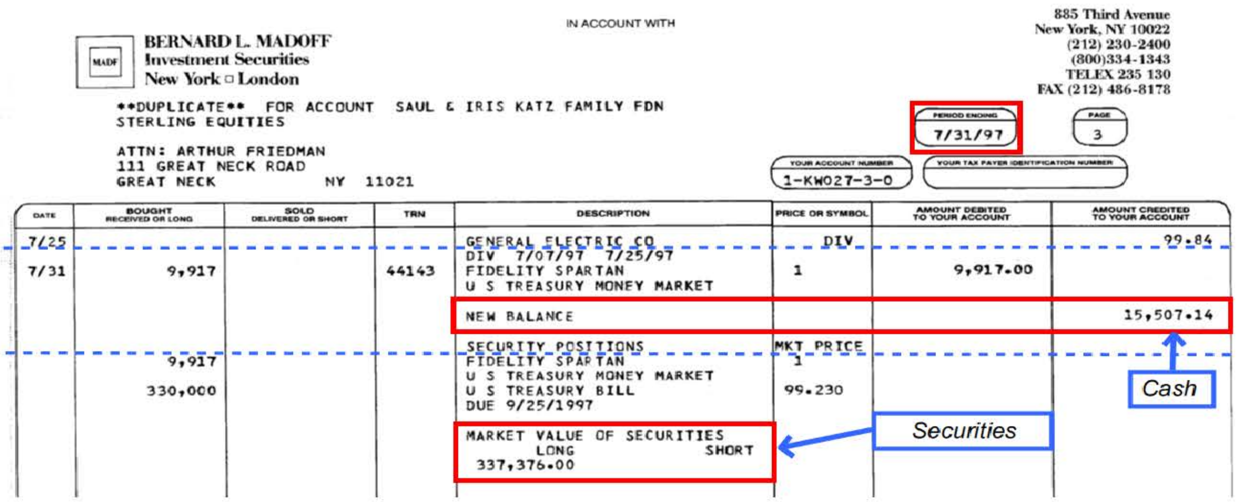
11 "Understanding Your Brokerage Accounts" at 2, SIFMA, SIPC, NASAA (March 7, 2007).

12 *E.g.*, Mets Limited Partnership Customer Statement, account number 1-KW423-3-0, August 31, 2007 (SE_T473536); Daniel Wilpon and Richard A. Wilpon as Custodian, account number 1-KW209-3-0, February 28, 2006 (SE_T165471).

13 Supplement to the Spartan U.S. Treasury Money Market Fund, Spartan U.S. Government Money Market Fund, and Spartan Money Market Fund June 29, 2005 Prospectus.

14 Saul & Iris Katz Family FDN, Sterling Equities Customer Statement, account number 1-KW027-3-0, July 31, 1997 (SE_T199000); Saul & Iris Katz Family FDN, Sterling Equities Customer Statement, account number 1-KW027-3-0, August 31, 1997 (SE_T199640).

Figure 4
Customer Statement Showing Ending Balance of Cash and Securities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STERLING EQUITIES

ATTN: ARTHUR FRIEDMAN
111 GREAT NECK ROAD
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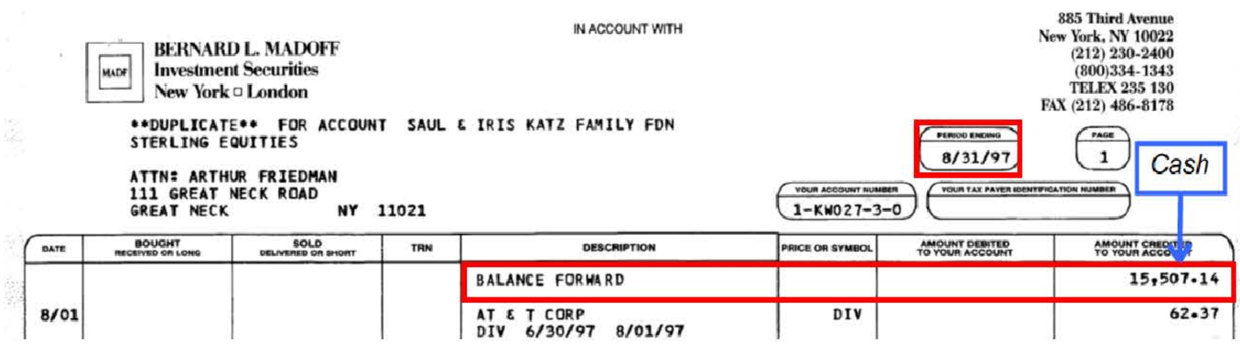
PERIOD ENDING 7/31/97 PAGE 3
YOUR ACCOUNT NUMBER 1-KW027-3-0 YOUR TAX PAYER IDENTIFICATION NUMBER

DATE	BOUGHT RECEIVED OR LONG	SOLD DELIVERED OR SHORT	TRN	DESCRIPTION	PRICE OR SYMBOL	AMOUNT DEBITED TO YOUR ACCOUNT	AMOUNT CREDITED TO YOUR ACCOUNT
7/25				GENERAL ELECTRIC CO DIV 7/07/97 7/25/97	DIV		99.84
7/31	9,917		44143	FIDELITY SPARTAN U S TREASURY MONEY MARKET	1	9,917.00	
				NEW BALANCE			15,507.14
				SECURITY POSITIONS	MKT PRICE		
	9,917			FIDELITY SPARTAN U S TREASURY MONEY MARKET	1		
	330,000			U S TREASURY BILL DUE 9/25/1997	99.230		
				MARKET VALUE OF SECURITIES LONG 337,376.00 SHORT			

Figure 5
Customer Statement Showing Beginning Balance of Cash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PERIOD ENDING 8/31/97 PAGE 1
YOUR ACCOUNT NUMBER 1-KW027-3-0 YOUR TAX PAYER IDENTIFICATION NUMBER

DATE	BOUGHT RECEIVED OR LONG	SOLD DELIVERED OR SHORT	TRN	DESCRIPTION	PRICE OR SYMBOL	AMOUNT DEBITED TO YOUR ACCOUNT	AMOUNT CREDITED TO YOUR ACCOUNT
				BALANCE FORWARD			15,507.14
8/01				AT & T CORP DIV 6/30/97 8/01/97	DIV		62.37

17. In the example above, Sterling's BLMIS account customer statement as of August 31, 1997 never reports the beginning balance of securities. In fact, it appears that prior to February 1993 neither the beginning balance nor the ending balance of securities was reported on Sterling's BLMIS account customer statements.[15] Sterling would have had to

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[15] *See e.g.*, Fred Wilpon and Iris J. Katz Customer Statement, account number 1-02341-3-0, November 30, 1991 (SE_T422590); Judith A. Wilpon and Iris J. Katz Customer Statement, account number 1-02342-3-0, March 31, 1991 (SE_T423919); Saul B Katz, Fred Wilpon, and Mae Rosenberg TIC, account number 1-KW033-3-0, January 31, 1993 (SE_T025096).

(and in fact did) look up the market price of each security in its portfolio, and calculate the total value of its portfolio manually.[16]

18. This is non-standard, atypical, and inconsistent with industry customs and practices. Industry guidance is that investors should be able to find their total beginning and ending balances on all statements, and furthermore be able to compare the total beginning balance of the current statement with the total ending balance of the previous statement.[17] This exercise would not be possible with Sterling's BLMIS customer statements. While Sterling's BLMIS account monthly customer statements showed both the ending cash position and the ending securities position for each month (at least after February 1993), the customer statements did not show an opening securities position each month, only the opening cash position. Prior to February 1993 it appears that customer statements did not show either the total beginning balance or total ending balance of securities.

C. Portfolio Management Reports

19. Sterling also received year-to-date summaries of its BLMIS accounts in reports called portfolio management reports ("PMRs"). Similar to the trade confirmations and customer statements, PMRs were also non-standard, atypical, and inconsistent with industry customs and practices. In addition to reporting historical performance for the account, numerous PMRs also listed an "expected rate of return" that purported to be the return that Sterling would receive in the future.[18] In the example below the "expected rate of return" is

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16 In many instances it appears that Sterling calculated the ending market value of securities on its own because its BLMIS account customer statements did not include the information. There are handwritten calculations on customer statements showing what appears to be the ending market value of securities based on the number of shares reported on the customer statements. *See e.g.*, Fred Wilpon and Iris J. Katz Customer Statement, account number 1-02341-3-0, November 30, 1991 (SE_T422590); Judith A. Wilpon and Iris J. Katz Customer Statement, account number 1-02342-3-0, March 31, 1991 (SE_T423919).

17 The Securities Industry and Financial Markets Association ("SIFMA") provides a checklist regarding brokerage account statements, indicating that investors should "find [their] beginning and ending balances" and also "compare the beginning balance of [their] current statement with the ending balance of the previous statement." "Understanding Your Brokerage Accounts" at 3, SIFMA, SIPC, NASAA (March 7, 2007).

18 Numerous PMRs from the late 1980s, produced by Sterling, include an "expected return." *See e.g.*, Saul B. Katz Portfolio Management Report, account number 1-01130-3, January 1, 1986 to July 31, 1986 (SE_T395626); Iris J. Katz Portfolio Management Report, account number 1-01138-3, January 1, 1987 to December 31, 1987 (SE_T433844 at 50).

reported to be 21 percent.[19]

Figure 6
Portfolio Management Report Showing "Expected Rate of Return"

082816012188 PORTFOLIO MANAGEMENT REPORT AS OF 12/31/87 PAGE 48

ACCOUNT # 1-01756-3 JUDITH A WILPON REPORT FOR THE PERIOD FROM 2/26/87 TO 12/31/87

INITIAL INVESTMENT	360,000.00CR
PROFITS UNDER EXPECTED RETURN FOR PREVIOUS YEAR	
ADJUSTMENTS	
CAPITAL ADDITIONS	
CAPITAL WITHDRAWALS	
NET WORKING CAPITAL	360,000.00CR
EXPECTED RATE OF RETURN 21%	
EXPECTED RETURN FOR 309 DAYS	64,001.10CR
REALIZED P/L	94,606.42CR
UNREALIZED P/L	52,669.25
PROFITS WITHDRAWN	
OVER/UNDER EXPECTED RETURN FOR CURRENT YEAR	22,063.93-
CURRENT CASH BALANCE	42,419.08
NET MARKET VALUE OF OPEN SECURITIES POSITIONS	444,356.25
TOTAL EQUITY	401,937.17CR

20. In my 25 years of experience working with account statements for myself as well as for my clients, I have never seen an account statement report an "expected rate of return." It is impossible for any investment adviser to predict the returns for a portfolio of stocks in the future. Including an "expected" return in a PMR makes no sense unless returns are being fabricated, and is on its face was a significant red flag that Madoff was not implementing the investment strategy he said he was implementing.

D. Reliance on Regulatory Scheme and Trade Organizations

21. In addition to calling Madoff's account statements "standard," Maine also argues that: (i) listing FINRA, NSX, SIPC, NSCC and DTC on customer statements would "entitle a customer to expect that his trade confirmations and account statements were accurate,"[20] and (ii) investors are "entitled to rely on the accuracy of a broker's statement primarily because the financial industry is one of the most heavily regulated industries," citing the Financial Industry Regulatory Authority, Inc. ("FINRA"), the SEC and New York's Investor Protection Bureau.[21] However these organizations do not review customer

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19 Judith A. Wilpon Portfolio Management Report, account number 1-01756-3, February 26, 1987 to December 31, 1987 (SE_T433844 at 57). The handwritten annotations are included in the original document.

20 Maine Report at 13.

21 Maine Report at 9.

statements, are not provided with customer statements even if they wanted to review them, nor do they monitor the accuracy of customer statements:

- The Securities Investor Protection Corporation ("SIPC") does not review, and is not responsible for reviewing any customer statements before a brokerage firm fails and is bankrupt. [22]

- FINRA is the largest independent regulator for all securities firms doing business in the U.S.[23] FINRA does not review trade confirmations or account statements, nor does it monitor these documents for accuracy.[24]

- The SEC brings enforcement actions against individuals and companies for violation of the securities laws, where "one of the major sources of information on which the SEC relies to bring enforcement action is investors themselves."[25] The SEC does not review trade confirmations or account statements, nor does it monitor these documents for accuracy—the SEC provides investors with a "wealth of educational information," and relies on investors like Sterling to identify issues based on this information;[26]

- The Depository Trust & Clearing Corporation ("DTCC") (which combined the NSCC and DTC in 1999) is a "huge data processing business, involving the safe transfer of securities ownership and settlement of trillions of dollars in trade obligations, under tight deadlines every day."[27] DTCC does not review trade confirmations or account statements, nor does it monitor these documents for accuracy.

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22 "How SIPC Protects *You*" SIPC Brochure (2007).

23 About The Financial Industry Regulatory Authority, FINRA (last visited December 8, 2011), http://www.finra.org.

24 Rather, FINRA instructs investors to regularly monitor their accounts themselves. *FINRA* (November 2008), Internet Archive: WayBack Machine (last visited December 5, 2011), http://web.archive.org/web/20081113031540/http://www.finra.org/Investors/SmartInvesting/GettingStarted/OpeningaBrokerageAccount/index.htm.

25 The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation (last visited December 9, 2011), http://www.sec.gov/about/whatwedo.shtml.

26 The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation (last visited December 9, 2011), http://www.sec.gov/about/whatwedo.shtml.

27 An Introduction to DTCC: Services and Capabilities, DTCC, (last visited December 8, 2011), http://www.dtcc.com/downloads/about/Introduction_to_DTCC.pdf.

- New York's Investor Protection Bureau is charged with enforcing the New York State securities law, commonly known as the Martin Act.[28] The Investor Protection Bureau does not review trade confirmations or account statements, nor does it monitor these documents for accuracy.

- The National Stock Exchange ("NSX") is an all-electronic stock exchange (formerly the Cincinnati Stock Exchange).[29] Stock exchanges do not review trade confirmations or account statements, nor do they monitor these documents for accuracy.

22. Nowhere do any of these organizations identify that they opine on investment strategies or ensure the accuracy of account statements or trade confirmations as part of their mandate. Contrary to Maine's assertion, neither the existence of these organizations, nor their "presence" on BLMIS's fictitious customer statements, entitled customers such as Sterling to conclude that their trade confirmations or account statements were accurate.

IV. Maine Mischaracterizes the Investment Management Industry

A. Reviewing Statements

23. Maine states that most investors "look at the bottom line" on a customer statement and "then file the statement away to give to their tax preparer."[30] Based on my experience, this is <u>not</u> what most high net worth, sophisticated investors do. There is substantial industry guidance from numerous sources which all provide express direction that investors carefully examine their statements in detail. For example, FINRA and the Investor Protection Bureau both provide guidance to investors to actively monitor and review account statements:

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[28] About the Investor Protection Bureau (last visited December 9, 2011), http://www.ag.ny.gov/bureaus/investor_protection/about.html.

[29] <u>History: National Stock Exchange</u>, NSX: National Stock Exchange (last visited December 8, 2011), http://www.nsx.com/content/history.

[30] Maine Report at 11.

- FINRA's website has a section entitled "What to Expect When You Open a Brokerage Account," which offers guidance for investors opening a brokerage account. The publication instructs investors to, among other things, "monitor [their account] activity regularly" and "review all of [their] account statements and trade confirmations for any errors;"[31] and

- The Investor Protection Bureau at the Office of the Attorney General of New York published a document entitled "Making an Investment: Your Brokerage Account." Among other things, the document highlights the importance of monitoring accounts, and states that "account statements are an important key to controlling your investments," advising investors to review their account statements carefully. The publication also emphasizes the added importance to "review and understand [one's] monthly statements" when the investor has given discretionary authority to the broker.[32]

24. Madoff's own fictitious trade confirmations even stated that "if any detail shown herein is not in accordance with your understanding of the transaction, please notify us at once."[33]

B. Due Diligence

25. There is a glaring omission in the Maine Report—the concept of due diligence. While Maine blanketly states that wealthy individuals hire professionals to manage their investment securities because they are too "busy doing whatever has made them successful,"[34] Maine is completely silent on the role of due diligence with regard to the professional managing an investor's investment securities (i.e., an investment adviser). Maine's conclusion assumes that the "client" here is a small individual client. This is not

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[31] *FINRA* (November 2008), Internet Archive: WayBack Machine (last visited December 5, 2011), http://web.archive.org/web/20081113031540/http://www.finra.org/Investors/SmartInvesting/GettingStarted/OpeningaBrokerageAccount/index.htm.

[32] "Making an Investment: Your Brokerage Account," Investor Protection Bureau, Office of the Attorney General (2008).

[33] *See e.g.*, Trade Confirmation for Sale of Eastman Kodak Stock, settlement date of January 16, 1989 (SE_T420002).

[34] Maine Report at 3. The suggestion that Madoff was a mere "middle man" (Maine Report at 2) is not accurate (*see* Pomerantz Report at 60).

the case here. Sterling had hundreds of accounts with Madoff, worth nearly $1 billion in the aggregate at its zenith. Sterling is a large sophisticated client with a personal and deeply dependent professional relationship with Madoff. Madoff was not simply a generic "executing broker," rather, he was at all times serving Sterling as a full-blown investment adviser and it is, as I detailed in my Initial Report, consistent with industry customs and practices to conduct onsite, in depth, independent due diligence on (among other things) the investment adviser and his/her operations (*see* Pomerantz Report at 19-25).

26. Wealthy individuals, such as Sterling, fully recognize the importance of ongoing evaluation and risk assessment, and a key component of the evaluation process in selecting an investment adviser is due diligence.[35] Due diligence performed by any investor both prior to making an investment decision and especially during the life of investments—whether buying stock or investing in a billion dollar hedge fund—is necessary to (among other things) ensure that investments are achieving the right amount of reward with the commensurate level of risk, to fully understand the strategy and to understand and respond to red flags and/or indicia of fraud. Sterling's own hedge fund, Sterling Stamos, was familiar with the due diligence process and performed systematic due diligence on both potential and existing investments on behalf of investors, including Sterling, and its own capital.[36]

27. Due diligence for discretionary brokerage accounts as compared to non-discretionary brokerage accounts is particularly essential. If an investor is turning over all trading decision-making and authority to another individual, to the tune of hundreds of millions of dollars, continued diligence, monitoring and investigation by the investor is not only warranted, but typical.

28. The closest Maine comes to acknowledging due diligence is when he concludes without

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35 Maine states that "it is unlikely that customers who are not financial market experts will achieve as good a return as will a professional." (Maine Report at 4). This point is of no consequence and certainly does not negate the important industry customs and practices of constantly and rigorously evaluating an investment adviser throughout the life of an investment relationship. *See* Pomerantz Report at 22-24.

36 *See* Pomerantz Report at 24-25.

any foundation that "the customer has no way of policing the broker's internal operation, and consequently is not required to be concerned about it."[37] This sweeping generalization is false and not at all consistent with industry practice (as Sterling's own hedge fund, Sterling Stamos, fully understood). Investors are and should always be concerned about "internal operations," which is precisely why they perform, and/or hire consultants to perform, standard due diligence. Furthermore, warning signs or red flags that question a broker's internal operations (e.g., Bayou) not only prompt additional due diligence but are themselves tell tale signs of fraud.[38]

C. Paper Statements

29. Maine states that "there is nothing unusual about a broker issuing trade confirmations and brokerage statements in paper form only."[39] However, by no later than 2000, the practice of allowing customers electronic access to their accounts was mainstreamed.[40] By the mid 2000s, Madoff's continued use of paper statements only was very unusual.

30. To better understand the extent to which broker-dealers (recognizing Madoff was far more than a mere executing broker) offered electronic access in the mid 2000s I examined the top 25 independent broker-dealers in 2005 by revenue. I then used a historical archive of web pages to search the websites for these broker-dealers circa 2005.[41] Of the 20 broker-dealers that had websites available in the time period, 19 indicated that they offered electronic access to account information.[42] That is, 95 percent of the top independent broker-dealers in the 2005 time period offered electronic access.

31. It was even more unusual and atypical in so much as that Madoff was touted in the media

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[37] Maine Report at 11.

[38] *See* Pomerantz Report at 51-55.

[39] Maine Report at 8.

[40] *See* Pomerantz Report at 26-28.

[41] Internet Archives, Wayback Machine (last visited December 8, 2011), http://www.archive.org/web/web.php.

[42] The other 5 (20 + 5 = 25) did not have information in the archive of historical websites. However, each of these broker dealers appears to offer electronic access today based on a review of their current websites.

as a global leader in the use of technology.[43] BLMIS's marketing materials highlighted its ability in this area, specifically stating:

> Moreover, Madoff Securities' computerized transaction processing means that the firm can customize client reports and **deliver them electronically in whatever format best meets the needs of customers**.[44]

32. Ultimately, Maine's opinion on Madoff's exclusive use of paper statements for customers is incorrect, and represents a departure from well-known, well-established industry customs and practices.

D. Fee Structure

33. Maine states that investment advisers are generally compensated in one of three ways: "they can charge clients a fee, they can generate commissions on trades, or they can employ some combination of the two methods."[45] It is a gross mischaracterization to suggest that trade commissions are one of the exclusive ways in which investment advisers such as Madoff are "generally compensated."

34. First, roughly 95 percent of investment advisers registered with the SEC are not broker-dealers.[46] None of these investment advisers would ever make any money if investors only paid per trade commissions for executing transactions. Investment advisers charge substantial management and incentive/performance fees well above share-based commissions.

35. Second, for those few investment advisers that are also broker-dealers (roughly 5 percent of Registered Investment Advisors are registered as broker-dealers as well), charging only trade commissions consistent with broker-dealer activities would similarly result in zero

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43 *See* Pomerantz Report at 26-28.

44 Fax to Arthur Friedman from Fleet Bank (October 30, 2000) (SE_T554021-29).

45 Maine Report at 5.

46 U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers, January 2011. The percent of investment advisers who are not registered with the SEC and are also not broker-dealers is likely even higher than 95 percent.

income for investment adviser-related activities.

36. As detailed in my initial report, by charging only trade commissions, Madoff left hundreds of millions of dollars on the table.[47] For example, hedge funds typically charge both management and performance fees, where management fees are typically charged as a percentage of assets under management and compensate the adviser for managing the client's money, and performance fees are typically charged as a percentage of profits and compensate the adviser for making money for the client.[48] This aligns the goals of the adviser with those of the client; if the account does well, both the adviser and the client make money. By charging commissions, however, a broker makes more money solely with a higher number of transactions, regardless of the performance for customers.

37. As discussed in my Initial Report, had Madoff charged a "1-and-20" fee structure—significantly more common in the industry—Sterling would have paid $212.4 million in fees between 1996 and 2008.[49] This is, on average, nearly $12 million more per year than what Sterling was supposedly charged under the commission structure or, between 1996 and 2008, Madoff willingly passed on well over $140 million in fees. Sterling Stamos itself charge fees of "1-and-5 over 5" for its services as a fund of funds.[50]

38. Madoff's fee structure, where he only supposedly charged commissions for executing trades, deviated significantly from industry customs and practices.

V. Mr. Maine Ignores the Facts

A. Sterling Is A Sophisticated Investor

39. Maine likens Sterling to "most brokerage clients" in his discussion of what is typical behavior in the industry.[51] However, Sterling is not like "most brokerage clients." As

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47 *See* Pomerantz Report at 97-98.
48 *See* Pomerantz Report at 29.
49 *See* Pomerantz Report at 97.
50 E.g., Sterling Stamos Security Fund, L.P. (February 2005) (SSMT00026027-59 at 54).
51 Maine Report at 10.

detailed in my Initial Report, Sterling is rightly assumed to be a sophisticated investor. [52] Among other things, Sterling manages a diverse network of sports-related, real estate and other assets, sits on boards of major corporations, including financial institutions, has its own hedge fund, and describes its own level of financial expertise as "high" and consistent with that of a sophisticated investor.[53]

40. Sterling also served as a fiduciary in its capacity as Sponsor and Trustee of its 401(k) Plan. Sterling assessed and selected investment alternatives, including Madoff, on behalf of plan participants.[54]

41. Additionally, Sterling created "double-up" accounts to leverage the highly unusual lack of volatility in the BLMIS accounts. Sterling would borrow $1 for every $1 in its account, invest these borrowed funds with Madoff, double the returns and earn a "vig" on the difference between the return generated by Madoff and the rate they paid on the loan.[55] Moreover, the "double-up" accounts were not typical brokerage accounts—they carried with them certain contractual legal obligations about what could be purchased, with limitations on same.

42. Finally, Sterling managed and administrated over 180 "referral accounts" with BLMIS, and tracked, discussed and monitored the performance of these accounts over time.

43. Based on the aforementioned, any likening of Sterling to "most brokerage clients" is misleading.

B. Sterling Monitored Its Accounts

44. As discussed above, Maine theorizes that investors just "look at the bottom line" on customer statements and "then file the statement away to give to their tax preparer."[56]

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[52] *See* Pomerantz Report at Section IV.

[53] *See* Pomerantz Report at 10-12.

[54] "401(k) Plans for Small Businesses" U.S. Department of Labor and Department of the Treasury (IRS Publication 4222) at 4-7. (October 2010).

[55] *See* Pomerantz Report at 11.

[56] Maine Report at 11.

Even if this sweeping generalization could apply to some random investors, it certainly did not apply here. Sterling actively monitored its returns and reviewed customer statements, for more than the "bottom line," on a consistent basis. A few examples for illustrative purpose include, but are not limited to, the following:

a. In the mid-to-late 1980s, Sterling partner Arthur Friedman tracked stock and option prices listed on Sterling's BLMIS customer statements, and compared them to the daily range in the market;[57]

b. Sterling monitored accounts to ensure that each was maximizing the opportunity to invest with Madoff. Sterling called it an "efficiency factor," and noted that based on Madoff's purported investment strategy, there was an efficiency to maintaining a certain level of investment in each account;[58]

c. Sterling performed calculations, based on information in its customer statements, to try and replicate Madoff's strategy;[59]

d. Arthur Friedman calculated maximum gains and losses based on information on Sterling's BLMIS customer statements, and compared these calculations with actual returns after Madoff unwound the purported trades;[60]

e. In 1996 and annually between 2000 and 2004, Sterling compared its BLMIS account returns against the Dow Jones Industrial Average ("DJIA") and the 10-year bond yield;[61]

f. Sterling maintained "Hell Sheets" tracking the returns by account for each

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57 Arthur Friedman Dep. 124, June 22, 2010.

58 Arthur Friedman Dep. 338-364, June 23, 2010.

59 Friedman Dep. 144-145, June 22, 2010.

60 Arthur Friedman Dep. 123-124, June 22, 2010; Arthur Friedman Handwritten Maximum Gain & Loss Analysis (1987) (SE_T396134 at 36).

61 Sterling kept a monthly Excel sheet tracking the balances in its BLMIS accounts. Arthur Friedman Dep. 336, 396, June 23, 2010. In spreadsheets containing account balances as of December 31, 2000, 2001, and 2002, Sterling also included entries listing Sterling's BLMIS annual returns followed by the DJIA annual returns. 1996 (SE_T572478); 2000 (SE_T571565); 2001 (SE_T571703); 2002 (SE_T571973); 2003 (SE_T572124); 2004 (SE_T572302); *See also* Spreadsheet titled "Madoff vs. DJIA Annual Percentage Change" (2005) (SE_T472003).

month;[62]

g. Sterling complained to Madoff when Madoff was not "in the market" at the end of 2003;[63] and

h. Sterling discussed Madoff rates of return at Board meetings, when Madoff was supposedly "in" and "out" of the market, how he compared to Sterling Stamos's returns and relied on Madoff rates of return predictions for cash flow projections.[64]

45. These examples underscore the fact that Sterling was not a "bottom line" only investor (as Maine describes that term). Far from just monitoring the "bottom line," Sterling actively reviewed customer statements, performed calculations based on account statements, and monitored its BLMIS account returns.

C. Sterling's Account Paperwork

46. While Maine appears to label Sterling's BLMIS accounts as discretionary brokerage accounts, and characterizes Madoff as buying and selling baskets of securities that were allocated to customers in a "functionally similar manner" to a hedge fund or mutual fund,[65] the "paperwork" completed by Sterling to create accounts at BLMIS contradict these notions.

47. For example, the paperwork on file for the BLMIS account of Sterling's Saul Katz includes a Customer Agreement between BLMIS and Saul Katz that describes a non-

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62 Excel files referred to as "Hell Sheets" (SE_T571565), (SE_T571703), (SE_T571973). Hell Sheets were account maintenance files initially maintained by Helene Kravitz. Arthur Friedman Dep. 336, June 23, 2010. Arthur Friedman Dep. 396, June 24, 2010.

63 Friedman Memorandum re: Madoff (January 6, 2004) (SE_T021058). The memo mentions that BLMIS was not invested in the market in December, when the market had been up 4 percent.

64 Meeting minutes from a January 24, 2005 Management Meeting list "2004 Results" under the header "Madoff." Management Meeting Minutes (January 24, 2005) (SE_T668387-96). While the date on the minutes page says January 10, 2004, it is attached to an agenda dated January 24, 2005. *See also e.g.*, Management Meeting Minutes (February 25, 2008) (SE_T668939-41); "New York Mets Cash Receipts and Disbursements" (2007) (SE_T619584).

65 Maine Report at 3.

discretionary account where "all orders for the purchase or sale of securities and other property will be authorized by the Customer."[66] This description of the relationship between BLMIS and Sterling is not consistent with Maine's description of a discretionary account. However, it is consistent with Maine's description of a non-discretionary account where "the broker must obtain the customer's consent prior to making any trades."[67]

48. Despite the fact that Sterling's paperwork reflected a non-discretionary account, Sterling reported that Madoff-related accounts were discretionary accounts, and characterized them as such in draft marketing materials for the 401(k) plan it sponsored for its employees.[68] Inconsistent with Sterling's paperwork, at all times since the inception of the investment relationship, Madoff had full discretion over Sterling's BLMIS accounts. Madoff served as investment adviser, executing broker, administrator and custodian (i.e., he was his own "chief cook and bottlewasher" as well). Not only did Sterling market Madoff as such in its 401(k) marketing materials, it touted and spoke of Madoff as one of the world's leading hedge funds.[69]

D. BLMIS's Business Model Was Not "Normal"

49. Maine states that the "apparent normality of BLMIS' business model provides yet another reason for an investor to trust that BLMIS was a legitimate enterprise and that its confirmation and statements were accurate and reliable."[70] This statement could not be further from reality. Beyond exceptionally consistent investment returns—itself quite abnormal—the "business model" was highly atypical, downright illogical, and created numerous red flags that Madoff was not engaged in the strategy he purported to follow.

50. By allegedly spurning a collective vehicle structure, like a hedge fund or mutual fund, Madoff incurred significant additional operational costs and denied himself the economic

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66 Customer Agreement, Saul Katz 1-KW025-30/40 (AMF00079644-47 at 45).

67 Maine Report at 5.

68 Discretionary Brokerage Account at Bernard L. Madoff Investment Securities, Arthur Friedman Dep. Ex. AF-34 (June 24, 2010) (SE_T011998).

69 *See* Pomerantz Report at 86.

70 Maine Report at 14.

benefit of economies of scale, ever-present in the investment management industry. By assuming a fee structure that was purely commission-based, Madoff further denied himself significant personal profit that would have been available under a more traditional, and indeed normal, fee structure that incorporated both asset based management fees and performance fees.

51. Finally, as discussed throughout my Initial Report, there were numerous red flags throughout Sterling's 23 year investment relationship that Madoff was not engaged in the strategy he purported to follow, were rife with the opportunity for fraud, and/or were virtual impossibilities where the only rational or reasonable explanation was fraud. Indeed, there was very little that was "normal" about Madoff or BLMIS.

VI. Conclusions

52. As shown above, the Maine Report mischaracterizes Madoff's trade confirmations and account statements as "entirely standard" when in fact they were non-standard, atypical, and excluded the type of information that investors would have expected. In addition, Maine's characterization of the investment management industry is misleading with respect to due diligence performed by investors, typical fee structures for investment advisers, and the use of paper-only account statements. Finally, the Maine Report does not incorporate any of the facts specific to the case that contradict Maine's characterization of a "typical" investor or description of Madoff's operations. In particular, Maine ignores the fact that Sterling is a sophisticated investor monitoring activities on its account statements, and ignores the fact that the legal paperwork underlying Sterling's accounts is inconsistent with how both Maine and Sterling characterize investment accounts with Madoff. Ultimately, Maine concludes erroneously that the BLMIS business model is "normal" when in fact it was highly atypical, downright illogical, and created numerous red flags.

Dr. Steve Pomerantz

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