UNITED STATES DISTRICT 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)
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, Plaintiff, v. SAUL B. KATZ, et al., Defendants.	Adv. Pro. No. 10-5287 (BRL) 11-CV-03605 (JSR) (HBP)

TRUSTEE'S MEMORANDUM OF LAW IN SUPPORT OF MOTION IN LIMINE NO. 2 TO EXCLUDE ALL EVIDENCE AND ARGUMENTS RELATING TO THE INACTION AND/OR FAILURES OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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Irving H. Picard (the "Trustee"), as trustee for the substantively consolidated liquidation of the business of Bernard L. Madoff Investment Securities LLC ("BLMIS") and Bernard L. Madoff ("Madoff"), under the Securities Investor Protection Act ("SIPA") 78aa *et seq*., by and through his undersigned counsel, hereby respectfully submits this Memorandum of Law in Support of Motion in Limine No. 2 to Exclude All Evidence and Arguments Relating to the Inaction and/or Failures of the United States Securities and Exchange Commission ("SEC") and Supporting March 5, 2012 Declaration of David Sheehan, attached hereto as Exhibit 1 (the "Motion"). For the reasons set forth below, such evidence and arguments should be excluded from the trial of this matter.

PRELIMINARY STATEMENT

As their pretrial disclosures and prior briefings telegraph, the Defendants will try to create a sideshow at trial about the SEC.[1] They will seek to introduce evidence about the SEC's failure to uncover Madoff's Ponzi scheme. They will likely argue that the SEC "cleared" Madoff, the Defendants relied on the SEC "clearing" Madoff, and if the SEC could not readily discover Madoff's fraud, the Defendants could not reasonably have been expected to discover it and, thus, acted in good faith.

The activities of the SEC, however, are not relevant here. The specific issues for trial before the jury are predicated upon what the *Defendants* did or did not do to satisfy their burden of proving *their* good faith. The Court has been resolute in holding that the legal applicable

[1] *See*, *e.g.*, Defendants' Pretrial Disclosures, dated Feb. 27, 2012 ("Pretrial Disclosures") (identifying as a trial exhibit the SEC Office of Investigations' 457-page report, "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme" (the "OIG Report")); Mem. of Law in Support of the Sterling Defs.' Mot. to Dismiss the Am. Compl. or, in the Alternative, for Summary Judgment, at 2, 38, 72, 74, 78-79, filed July 7, 2011, Dkt. No. 20; Mem. of Law in Support of Defs.' Mot. for Summary Judgment at 2, filed Jan. 26, 2012, Dkt. No. 86.

standard for the determination of the Defendants' good faith or, as the Trustee contends, their lack of good faith, is not "inquiry notice" or negligence, but rather a "subjective standard." *Picard v. Katz*, ---B.R.----, 11 Civ. 3605, 2011 WL 4448638, at *5 (S.D.N.Y. Sept. 27, 2011). Specifically, the Defendants lack good faith if they blinded themselves to "red flags" suggesting a high probability of fraud at BLMIS. *Id*. Whatever the SEC did or did not do, in its role as a regulator, with regards to Madoff is not probative of whether the Defendants willfully blinded themselves to a high probability of fraud based upon, among other things, the Defendants' quarter century of improbable returns as well as the warnings they received from sophisticated and trusted investment partners and employees. Any possible probative value of such evidence is far outweighed by the unfair prejudice and confusion to the jury by misleading it to believe that the SEC's failure absolves the Defendants of the consequences of their own actions.

I. BACKGROUND

Madoff and BLMIS were the focus of one SEC investigation (the Northeast Regional Office Enforcement Staff Investigation from January 2006 through January 2008) and two SEC cause examinations: (i) the Office of Compliance Inspections and Examinations examination (December 2003 – May 2004); and (ii) the Northeast Regional Office examination (December 2004 – September 2005). Notably, the latter two inspections did not focus on BLMIS' Investment Advisory ("IA") Business where the Defendants were customers,[2] and the former focused on regulatory and disclosure "[i]ssues [u]nrelated to a Ponzi Scheme Investigation."[3] As

[2] OIG Report at 93-94, 160-164, 167-174.

[3] OIG Report at 266. As a result of this SEC investigation, BLMIS was forced to register as an IA in 2006. OIG Report at 301-302, 348-350**.**

per SEC practice, these inspections were unknown to the general public.[4] They were also unknown to the Defendants.[5] After Madoff confessed to running a Ponzi scheme, the facts of these inspections were later published in the SEC Office of Investigations' report, "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme" (the "OIG Report").[6] The SEC also questioned Madoff in 1992 in a brief, limited cause examination of BLMIS in connection with the SEC's investigation of BLMIS investor Avellino & Bienes. This examination was limited to the SEC's request of third-party verification from Madoff that Avellino & Bienes held certain security positions with BLMIS in properly segregated accounts.

The record is devoid of any evidence that in dealing with Madoff, the Defendants knew of and contemporaneously relied on any of the SEC's post-2000 inspections. Indeed, when asked to identify and explain the bases for their purported reliance on the SEC, the most the Defendants could muster is a hazy recollection of the 1992 SEC examination of BLMIS in connection with the Avellino & Bienes investigation, a decade before any of the red flags

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[4] *See* United States Securities and Exchange Commission, "Investigations by the SEC," http://www.sec.gov/answers/investg.htm (last visited February 29, 2012); *see also* United States Securities and Exchange Commission, "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation," http://www.sec.gov/about/whatwedo.shtml (last visited February 29, 2012).

[5] *See, e.g.*, *Picard v. Katz*, Deposition of Saul Katz, 11 Civ. 03605, dated Jan. 13, 2012, at 250:21 – 251:1; *Picard v. Katz*, Deposition of Fred Wilpon, 11 Civ. 03605, dated Jan. 10, 2012, at 206:8 – 16, 207:3 – 17. True and correct copies of excerpts from the Katz Deposition and the Wilpon Deposition are attached to the Declaration of David J. Sheehan dated Mar. 5, 2012 ("Sheehan Decl.") as Exs. 1 and 2, respectively.

[6] This Court should strike the OIG Report because its probative value is substantially outweighed by its prejudicial effect, as set forth fully below. *See* Fed. R. Evid. 403 (2011).

appeared in this case.[7] Further, not a single document produced by the Defendants suggests that the Defendants knew of the SEC's investigations of BLMIS, much less relied on them.

II. ARGUMENT

Evidence is relevant if it has "any tendency to make a fact more or less probable than it would be without the evidence." Fed. R. Evid. 401 (2011). Only "relevant" evidence is admissible at trial. Fed. R. Evid. 402 (2011). "The court may exclude relevant evidence if its probative value is substantially outweighed" by the dangers of "unfair prejudice, confusing the issues, misleading the jury, undue delay, wasting time, or needlessly presenting cumulative evidence." Fed. R. Evid. 403 (2011). Prejudice is "unfair" if the evidence has "an undue tendency to suggest decision on an improper basis." *Perry v. Ethan Allen, Inc.*, 115 F.3d 143, 151 (2d Cir. 1997) (internal citation omitted).

There is no contemporaneous record evidence to support the Defendants' defense that they deliberately chose not to conduct any independent investigation or due diligence in the face of intensifying red flags because (i) BLMIS was a regulated entity (ii) who had been inspected and "cleared" of wrong-doing by the SEC. This Court should not countenance attempts to introduce any evidence or arguments to this effect at trial, as the SEC's inaction and failures vis-à-vis BLMIS are beyond the scope of this case and inadmissible under Federal Rule of Evidence ("Rule") 402. The evidence is also unfairly prejudicial, confusing, misleading, and, therefore, inadmissible under Rule 403.

[7] Sheehan Decl. Ex. 1 at 249:16 – 250:4 (Katz describing the 1992 examination as "an issue with some accountants in Florida"); Sheehan Decl. Ex. 2 at 144:14 – 24 (Wilpon describing the 1992 inspection as "a time when some Florida investors were sanctioned or something by the SEC").

A. Evidence and Arguments Concerning the SEC's Inaction Are Irrelevant and Prejudicial

The SEC is, of course, not the party who is on trial here. Its failure to uncover Madoff's fraud is not probative or related to how the Defendants reacted—or consciously chose not to react—to the red flags tied to their hundreds of investment accounts with Madoff. It is undisputed that the SEC never monitored the Defendants' investment accounts (or any others). Nor did the SEC enjoy a 20-plus year personal—and more than one billion dollar investment—relationship with Madoff, with unique access to him and his IA Business. Put simply, evidence about the SEC's inaction vis-à-vis the IA Business does not make it more or less probable that the Defendants acted with good faith or lack thereof. *See In re Sept. 11 Lit.*, 621 F. Supp. 2d 131, 146 (S.D.N.Y. 2009) (when the government or its agencies are non-parties, and the focus of the trial is "what [the defendants] knew and should have known" it follows that "[w]hat the . . . government knew and failed to pass on is irrelevant. What the government failed even to learn or fully apprehend is also irrelevant"). Accordingly, it should be excluded under Rule 402. Fed. R. Evid. 402.

Additionally, the admission of this evidence will likely cause undue prejudice and confusion because: (i) it will unfairly imply to the jury that the lack of action by the SEC vis-à-vis BLMIS and the Defendants' inaction regarding red flags tied to their BLMIS investments are correlated or based on similar information; (ii) it would suggest that the alleged failure of the SEC is somehow a defense to the Defendants' willful blindness; (iii) it would unreasonably incite the passions and biases of the jury to blame the government; and (iv) it would create a wasteful mini-trial regarding the SEC's much maligned failure to uncover Madoff's fraud before it was too late. *See English v. Dist. of Columbia*, 651 F.3d 1, 10 (D.C. Cir. 2011) (affirming lower court's exclusion of a government report as highly prejudicial, in part, because it would

likely result in a mini-trial about the efficacy of government). Furthermore, allowing such evidence opens the door to a potentially anomalous result where bad faith investors can be insulated from liability due to unrelated government conduct.[8] When evidence has an "undue tendency to suggest decision on an improper basis" it is properly excluded under Rule 403. *Perry*, 115 F.3d at 151; *see also Highland Cap. Mgm't, L.P. v. Schneider*, 551 F. Supp. 2d 173, 191-93 (S.D.N.Y. 2008) (evidence causing an unfair prejudice must be excluded).

B. Evidence and Arguments that the SEC "Cleared" BLMIS Are Irrelevant and Prejudicial

Evidence concerning the SEC's inspections of BLMIS has no probative value and is highly prejudicial. The Trustee anticipates the Defendants will now try and argue at trial that because the SEC "cleared" Madoff during their inspections of BLMIS, the Defendants cannot be liable. But this evidence lacks probative value because the red flags and indicia of fraud in this action were *not* the subject of the SEC's investigations. *See In re Sept. 11 Lit.*, 621 F. Supp. 2d at 146-49 (evidence about the government's failures to apprehend terrorists and abort their plots was irrelevant, and thus inadmissible, in action against aviation defendants). Also, the 1992 examination predated the evidence of red flags deliberately ignored by the Defendants to be presented to the jury in this action and only tangentially involved Madoff and BLMIS. Finally, the Defendants cannot now credibly argue that they relied on the outcome of the SEC's post-2000 inspections of BLMIS since such information was not published until after Madoff

[8] As a matter of law, inaction and/or action by the SEC does not mean the investigated party was "cleared." *Graham v. S.E.C.*, 222 F.3d 994, 1008 (2d Cir. 2000); *see also S.E.C. v. Culpepper*, 270 F.2d 241, 248 (2d Cir. 1959) (same); *see also S.E.C. v. KPMG LLP*, 03 Civ. 671 (DLC), 2003 WL 21976733, at *4 (S.D.N.Y. Aug. 20, 2003).

confessed to his crimes and, more importantly, they have testified under oath that they had no knowledge of such inspections until *after* Madoff was arrested.[9]

In any event, whatever little probative value such evidence could have would be substantially outweighed by its prejudicial effect. First, the impression that the Defendants want to create—that the SEC's ratification of BLMIS's market-making business during its inspections, as well as its investigation that focused on regulatory issues and not on whether BLMIS was a Ponzi scheme, must mean it also "cleared" BLMIS's IA Business—is unduly prejudicial. This sort of "apples and oranges" evidence and argument is exactly the kind of misleading analysis that compelled the exclusion of similar evidence in the 2005 Bayou Ponzi scheme. Transcript of Oral Argument at 41:8-41:17, *In re Bayou Group, LLC*, No. 09 CV 2340 (PGG) (S.D.N.Y. May 2, 2011), Dkt. No. 38 (evidence about the NASD's ratification of an unrelated Bayou business will imply, unfairly, that the government ratified the business that operated as a Ponzi scheme). Second, this evidence is, by design, intended to mislead the jury into making unnecessary comparisons of the Defendants' failures vis-à-vis those of the SEC. This "blame the government more" approach was rejected recently in the September 11 litigation. *See In re Sept. 11 Lit.*, 621 F. Supp. 2d at 149 ("Permitting an inquiry into what fragments of information the various government agents knew, or should have known, and at what time, but did not tell the defendants, threatens thoroughly to confuse and prejudice the jury, distract it from the major issues of the case, and add to the trial substantial expense and delay."). This evidence is properly excluded under Rule 403. Fed. R. Evid. 403.

[9] *See* Sheehan Decl. Ex. 1 at 250:21 – 251:1; Sheehan Decl. Ex. 2 at 206:8 – 16, 207:3 – 17.

CONCLUSION

For all of the foregoing reasons, the Trustee respectfully requests that the Court grant his Motion in its entirety.

Dated: New York, New York
March 5, 2012

Respectfully submitted,

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