UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IRVING H. PICARD, Plaintiff, - against - SAUL B. KATZ, et al., Defendants.	11-CV-03605 (JSR) (HBP)

MEMORANDUM OF LAW IN OPPOSITION TO TRUSTEE'S 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

DAVIS POLK & WARDWELL LLP
450 Lexington Avenue
New York, New York 10017
(212) 450-4000

Attorneys for Defendants

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Defendants respectfully submit this memorandum of law in opposition to the Trustee's motion *in limine* to exclude all evidence and arguments relating to the inaction and failures of the United States Securities and Exchange Commission ("SEC").

PRELIMINARY STATEMENT

The central issue for trial is whether Defendants were "willfully blind" when they deposited funds into their brokerage accounts at Bernard L. Madoff Investment Securities LLC ("Madoff Securities") during the relevant two-year period. Defendants' knowledge of the SEC's investigations and oversight of Madoff Securities is relevant to the first prong of the willful blindness standard set forth in *Global-Tech Appliances, Inc. v. SEB, S.A.*, 131 S. Ct. 2060, 2070 (2011)—what Defendants actually believed. The Trustee intends to introduce evidence of what he calls "red flags" that supposedly should have alerted Defendants to the massive Ponzi scheme perpetrated by Bernard L. Madoff ("Madoff"). Through this and other motions *in limine*, however, the Trustee seeks to exclude evidence of the many "green flags" on which Defendants relied in forming and maintaining their trust in Madoff up until the day his fraud was revealed, including evidence related to SEC investigations of Madoff Securities that failed to unearth his wrongdoing. In assessing Defendants' state of mind, what they actually believed about Madoff and his firm, the jury must be allowed to hear all the information about Madoff that Defendants were aware of and took into consideration when they invested.

Evidence concerning the SEC investigations and examinations is also relevant to the second prong of the willful blindness standard—whether there was readily accessible information about the fraud to which Defendants turned a blind eye. As set forth in the report entitled "Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi

Scheme," issued by the Office of the Inspector General of the SEC ("SEC OIG Report"), available at http://www.sec.gov/news/studies/2009/oig-509.pdf, Madoff and Madoff Securities were investigated several times by the SEC and cleared every time. This is circumstantial evidence that the Madoff scheme was complex and well hidden, which makes it far less probable, if not entirely implausible, that Defendants had ready access to, and deliberately turned away from, information that they feared would confirm a scheme in which no securities were being purchased for their securities accounts. It is also evidence that Defendants' trust in Madoff was well founded. Indeed, the SEC itself has recognized that Madoff Securities customers relied on the absence of any regulatory action.

> "We also found that investors who may have been uncertain about whether to invest with Madoff were reassured by the fact that the SEC had investigated and/or examined Madoff, or entities that did business with Madoff, and found no evidence of fraud. Moreover, we found that Madoff proactively informed potential investors that the SEC had examined his operations. When potential investors expressed hesitation about investing with Madoff, he cited the prior SEC examinations to establish credibility and allay suspicions or investor doubts that may have arisen while due diligence was being conducted. Thus, the fact the SEC had conducted examinations and investigations and did not detect the fraud, lent credibility to Madoff's operations and had the effect of encouraging additional individuals and entities to invest with him." (SEC OIG Report at 25.)

The Trustee's attempt to block this evidence must be denied. While customers, Defendants knew that Madoff Securities was regulated by the SEC and relied on that regulatory regime. Defendants' Madoff Securities trade confirmations reflected on their face the regulatory and self-regulatory bodies they believed were part of the overall regulatory scheme. And, as the Trustee himself recognizes, they were aware of at least one SEC investigation of Madoff Securities in which they understood Madoff Securities and Madoff to have been deemed completely clean—an investigation portrayed by the

Trustee's fraud expert as a turning point in Madoff's fraud. Defendants' understanding of that investigation, and the absence of *any* regulatory action against Madoff Securities for almost fifty years, provided critical support for their trust in Madoff and is directly relevant to their state of mind—the principal issue for trial, not, as the Trustee contends, what "Defendants did or did not do." (Tr. *Limine* Mot. No. 2 at 1.) Defendants had no duty to do anything, and their reliance on the regulatory scheme they believed was ongoing is relevant evidence of their lack of willful blindness.

ARGUMENT

Relevant evidence is evidence having "any tendency to make a fact more or less probable than it would be without the evidence." Fed. R. Evid. 401. The "any tendency" admissibility threshold of Rule 401 is "minimal." *See United States v. Khan*, 787 F.2d 28, 34 (2d Cir. 1986). Exclusion under Rule 403 is only appropriate where the risk of prejudice is significant. *See Highland Capital Mgmt., L.P. v. Schneider*, 551 F. Supp. 2d 173, 177 (S.D.N.Y. 2008) ("Because Rule 403 excludes relevant evidence, 'it is an extraordinary remedy that must be used sparingly.'" (quoting *George v. Celotex Corp.*, 914 F.2d 26, 31 (2d Cir. 1990))); *United States v. Kaplan*, 490 F.3d 110, 122 (2d Cir. 2007) ("[R]elevant evidence is always prejudicial to one side . . . ."); *In re Blech Sec. Litig.*, No. 94 Civ. 7696, 2003 U.S. Dist. LEXIS 4650, at *68 (S.D.N.Y. Mar. 26, 2003) ("In conducting this balancing test, the general rule is that the balance should be struck in favor of admissi[bility]." (internal quotation marks omitted)).

Defendants' belief that Madoff Securities was regulated and never sanctioned and their knowledge of at least one SEC investigation in which Madoff Securities was completely cleared satisfies the minimal relevancy requirement. No serious concern that

the jury would draw improper inferences, let alone a sufficient likelihood of unfair prejudice, provides a basis for exclusion.

I. DEFENDANTS BELIEVED MADOFF SECURITIES WAS REGULATED, AND THE ABSENCE OF SANCTIONS WAS A "GREEN FLAG"

Madoff Securities was—and Defendants understood it to be—a registered broker dealer operating in one of the most highly regulated areas of the economy.[1] It was subject to oversight by many federal, state, and non-governmental entities, each of whom were, and are, responsible for protecting the interests of individual investors. Trade confirmations sent by Madoff Securities to Defendants listed the many regulatory bodies with which it was affiliated, including the Financial Industry Regulatory Authority (FINRA), the National Stock Exchange (NSX), the Securities Investor Protection Corporation (SIPC), the National Securities Clearing Corporation (NSCC), and the Depository Trust Corporation (DTC)—each, in whole or in part, overseen and/or regulated by the SEC. (Seshens Opp'n Decl., Ex. D.)

Defendants believed that these bodies were responsible for protecting them. For example, Fred Wilpon testified that he understood that Madoff Securities was regularly monitored by regulatory bodies, including NASDAQ and the SEC. (F. Wilpon Tr. 206:8-207:10 (Seshens Opp'n Decl., Ex. B).) Defendants were also aware that Madoff Securities had registered as an investment advisor in 2006, which subjected Madoff Securities to increased SEC oversight. (*See id.* 76:4-18.)

[1] (*See* Deposition Transcript of Saul Katz ("S. Katz Tr."), Jan. 13, 2012, 78:17-79:9 (Seshens Opp'n Decl., Ex. A); Deposition Transcript of Fred Wilpon ("F. Wilpon Tr."), Jan. 10, 2012, 46:2-5 (Seshens Opp'n Decl., Ex. B); Deposition Transcript of David Katz, Dec. 28, 2011, 221:16-23; 369:7-370:4 (Seshens Opp'n Decl., Ex. C).)

Additionally, Defendants were aware of a specific investigation conducted by the SEC in 1992 that Defendants understood to be a significant mark of Madoff's probity based on a report they received directly from Ira Sorkin, an experienced securities lawyer whom they knew at the time had been the former head of the SEC's New York office.[2] Far from a "hazy recollection," Fred Wilpon, for example, explained in detail his understanding that Madoff Securities had been given "a clean bill of health" by the SEC:

> "What I recall is that just by coincidence I happened to be in Howard Squadron's office, or the offices of Squadron. And my recollection is that Mr. Sorkin was there. He was a—he was a partner of—of Squadron. I don't know how this came about, but he—I think he was representing Mr. Madoff at the time. And the issue—there was some publicity about it, I know, about the two accountants. And the publicity then was that they were going to sanction—the SEC were going to sanction the accountants, but they did not find anything wrong at all with Mr. Madoff, or Mr. Madoff's firm. And Ike Sorkin told me that. He said something, he used some words, clean bill of health or something like that, with respect to that. And I remember that the newspapers reported and—that they had sent the money back." (*Id.* 205:12-206:4.)

In his *limine* motion the Trustee attempts to minimize the significance of this investigation by describing it as "brief" and "limited." (Tr. *Limine* Mot. No. 2 at 3.) But the Trustee's fraud expert, Mr. Dubinsky, himself has testified that the investigation was extremely consequential. According to Mr. Dubinsky, as a result of the SEC sanctioning the Florida accountants' operation, all of the customers who had been pooled, and thus indirect investors with Madoff Securities through the accountants, flooded in to be direct

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[2] (*See* F. Wilpon Tr. at 143:18-145:1; 204:18-206:7 (Seshens Opp'n Decl., Ex. B); S. Katz Tr., 249:16-250:20 (Seshens Opp'n Decl., Ex. A); Deposition Transcript of Michael Katz, Dec. 9, 2011, 321:7-23 (Seshens Opp'n Decl., Ex. E); Bankruptcy Rule 2004 Deposition Transcript of Saul Katz, Aug. 4, 2010, 52:3-53:6 (Seshens Opp'n Decl., Ex. F); *see also* Declaration of Fred Wilpon, Jan. 26, 2012, ¶ 7 (doc. no. 94); Declaration of Saul Katz, Jan. 26, 2012, ¶ 6 (doc. no. 91); Declaration of Michael Katz, Jan. 26, 2012, ¶ 6 (doc. no. 99); Declaration of David Katz, Jan. 26, 2012, ¶ 6 (doc. no. 95).)

customers, which in turn caused Madoff Securities to create a more sophisticated, scalable scheme for its greatly expanded customer base. (*See* Deposition Transcript of Bruce G. Dubinsky, Jan. 11, 2012, 42:3-43:10 (Seshens Opp'n Decl., Ex. G).) This was likely the real launch of the scheme, precipitated, ironically, by the sanctioning of the Florida accountants.

Further, the Trustee's argument that the SEC investigations are not relevant because they did not focus on Madoff Securities' *investment advisory* business is specious. Madoff Securities was, and was perceived to be, a single corporate entity and a registered broker. There is no evidence that any Defendant perceived it otherwise. To the extent Madoff Securities had legitimate operations, they likely helped to fool the SEC just as they helped to fool its customers, as Mr. Dubinsky recognized. (*Id.* 84:13-85:23.) And the portions of the SEC OIG Report cited by the Trustee describe investigations addressed to front-running allegations that Madoff was using his market-making activities to subsidize the returns of his *investment advisory* customers. (*See* Tr. *Limine* Mot. No. 2 at 2 (citing SEC OIG Report at 93-94, 160-64, 167-74).)

Finally, the Trustee contends that the SEC's 1992 investigation occurred "a decade before any of the red flags appeared in this case" (*id.* at 3-4), thereby abandoning reliance on any supposed evidence of willful blindness prior to 2002.

II. THE ABSENCE OF ANY REGULATORY ACTION AGAINST MADOFF SECURITIES IS RELEVANT TO DEFENDANTS' GOOD FAITH

The principal issue in the case is willful blindness. This requires the Trustee to prove that each Defendant held a *subjective belief* that there was a high probability that Madoff was engaged in a Ponzi scheme and that each such Defendant took deliberate action to turn away from easily accessible information for fear that it would have confirmed

his, her, or its suspicion. Evidence of Defendants' state of mind when they invested in Madoff Securities is, therefore, highly relevant. In fact, the Trustee's willful blindness case is composed entirely of circumstantial evidence of "red flags" that supposedly speak to Defendants' state of mind. Plainly, Defendants are equally entitled to put forward circumstantial evidence of a state of mind that was utterly inconsistent with willful blindness, including their reliance on the lack of any regulatory sanctions against Madoff Securities. *See Vinieris v. Byzantine Mar. Corp.*, 731 F.2d 1061, 1064 (2d Cir. 1984) (where "good faith" is at issue, the trial court should "follow[ ] a liberal policy in admitting evidence directed towards establishing . . . subjective state of mind").

Evidence concerning the many failed SEC investigations of Madoff Securities also is relevant to the second prong of the willful blindness test. Unlike Defendants, the SEC *had* readily accessible information that could have confirmed Madoff's fraud, including access to the inner workings of Madoff Securities' operations and Madoff Securities' trading records, and, even though the SEC affirmatively was looking for possible fraud, the SEC never saw it. Defendants, by contrast, had no such information, nor were they presented with any. How then is it possible, let alone probable, that Defendants deliberately turned away from confirmatory information when Defendants never had such information to begin with? It is not, and evidence concerning the SEC's many failures is relevant to that determination.

Accordingly, the SEC OIG Report and other evidence of Defendants' reliance on their understanding that Madoff Securities was regulated easily clears the minimal relevancy threshold. *See Khan*, 787 F.2d at 34. The concerns of prejudice or confusion articulated by the Trustee are superficial at best and do not outweigh the high probative

value of this evidence. *See Highland Capital Mgmt.*, 551 F. Supp. 2d at 177. Indeed, as noted above, the SEC itself has recognized that Madoff Securities customers relied on the absence of any regulatory action. (*See* SEC OIG Report at 25.)

The Trustee's arguments against the admissibility of the SEC OIG Report are inapposite. The Trustee's reliance on a ruling in *Bayou Group* is misplaced, as the court in that case explicitly rejected testimony regarding the government's failure to uncover a Ponzi scheme on the basis that "Bayou Hedge Funds *were not regulated* by the NASD or the SEC." Transcript of Oral Argument at 41:16-17, *In re Bayou Grp., LLC*, No. 09 Civ. 2340 (S.D.N.Y. May 2, 2011) (doc. no. 38) (emphasis added). By contrast, Madoff Securities was regulated by both. And *In re Sept. 11 Litigation* is similarly inapposite, as that decision found that "[w]hat the [defendants] learned from the governmental and agency sources is relevant." 621 F. Supp. 2d 131, 146 (S.D.N.Y. 2009).

CONCLUSION

For the reasons set forth above, Defendants respectfully request that the Court deny the Trustee's motion to exclude all evidence and arguments relating to the inaction and failures of the SEC.

Dated: New York, New York
March 12, 2012

DAVIS POLK & WARDWELL LLP

By: /s/ Robert F. Wise, Jr.

Robert F. Wise, Jr
Karen E. Wagner
Dana M. Seshens

450 Lexington Avenue
New York, New York 10017
Telephone: (212) 450-4000
Facsimile: (212) 701-5800

Attorneys for Defendants