Irving H. Picard v. Saul B. Katz et al
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Exhibit 2

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Picard v. Katz, No. 11 Civ. 3605 (JSR)
Rebuttal Report of John Maine

I. **Introduction**

I have been asked by Davis Polk & Wardwell LLP, counsel for Defendants, to review and comment on the report and conclusions of Dr. Steve Pomerantz (the "Pomerantz Report"), served on November 22, 2011. I provided an initial expert report in this matter on November 22, 2011. This report presents my response to the Pomerantz Report.

The Pomerantz Report is flawed, among other reasons, because it rests on two assumptions, neither of which is correct. First, Dr. Pomerantz ignores the fact that there are many individual Defendants named in this complaint, and instead assumes that the defendant is an institution called "Sterling" that is a sophisticated investor whose investment knowledge and expertise may properly be equated with that of an institutional investor. That assumption is not consistent with the evidence I have reviewed.

Second, the Pomerantz Report lists a number of things that Dr. Pomerantz terms "red flags," and assumes they would have indicated to an institutional investor that BLMIS was engaged in a fraud, indeed, a Ponzi scheme, and therefore would have indicated the same to Defendants. I do not think even an institutional investor would have reached this conclusion, even if all of these alleged "red flags" had been presented simultaneously to such an investor, which I understand they were not, particularly as Madoff had a thriving business and a fine reputation. In my experience, it is very rare for a broker to engage in a Ponzi scheme, and even more rare for a successful business person to do so. In any event, none of the items listed would have been a "red flag" to a retail brokerage customer, causing that retail customer to conclude his broker was engaged in a Ponzi scheme.

II. Dr. Pomerantz Misinterprets and/or Mischaracterizes the Terms "Sophisticated Investor" and "Institutional Investor"

One key foundation for the Pomerantz Report is the assumption that Defendants were the equivalent of institutional investors. *See*, *e.g.*, Pomerantz Report ¶ 25. Because that assumption is wrong, the Report is flawed.

Throughout his report, Dr. Pomerantz refers to the Sterling Defendants as "Sterling." My understanding, based on the information I have reviewed, is that the Defendants include individual partners of Sterling Equities, their children and other family members, partnerships and certain other entities. Investor sophistication, in my view, can only be evaluated on an individualized basis. Therefore, the Pomerantz Report fails to address the securities market sophistication of any particular Defendant. As there is no "Sterling," the Report is of little value.

Second, I disagree with the characterization of the Defendants as sophisticated investors based on the definitions of "sophisticated investor" employed by the Pomerantz Report. It is my opinion that the Report misinterprets and misapplies that term.

The Pomerantz Report offers three definitions of "sophisticated investor." Pomerantz Report ¶ 25 & n.21. Two are the SEC's regulatory definitions of "accredited investors" and "qualified purchasers." These terms have nothing to do with securities trading knowledge or experience. They define an investor based upon his or her wealth or income and are used in connection with determinations of when issuers or underwriters are required to register securities distributions. They are irrelevant to the consideration of whether a particular individual is so experienced in the securities markets that he may be considered an investment professional, as an institutional investor would be. In my experience, many individuals who would qualify as "accredited investors" or "qualified purchasers" solely on the basis of their wealth are, in fact,

entirely unsophisticated about the securities markets. And Dr. Pomerantz ignores a second step when considering whether a customer is a sophisticated investor—the broker must provide the customer with a suitability questionnaire to see if the customer really is sophisticated. The first step is not sufficient.

The remaining definition is attributed to the Municipal Securities Rulemaking Board, which defines a sophisticated investor as "having sufficient resources, market knowledge, and experience to understand and bear the risks involved in a particular investment." Like the Municipal Securities Rulemaking Board, it is my opinion that the term "sophisticated investor" implies more than wealth. In order to be a sophisticated investor in the securities markets, as distinct from, for example, real estate or media, an individual would need a substantial education or professional background in the securities markets and securities trading strategies.

From the information I have been provided, Defendants appear to be high net-worth customers, not sophisticated investors, and certainly not institutional investors. They lack the special skills, knowledge and experience in the securities industry that distinguish institutional investors from retail investors. My initial report addressed the many reasons why many wealthy people choose to invest with professional private wealth managers rather than manage their own investments. Typically, these individuals do not have the knowledge, skills and sophistication of professional investors, and generally lack the time or interest to manage their own securities investments.

My conclusion that no Defendant falls into the category of sophisticated or institutional investor is not changed by paragraph 25 of the Pomerantz Report, which lists "facts" supposedly demonstrating that "Sterling" was a sophisticated investor.

First, the list does not identify on the part of any Defendant extensive experience trading securities, or any background giving rise to "market knowledge." Second, based on the information made available to me, I believe the "facts" to lack any basis. For example, although I would agree that a person with a "deep understanding of hedge funds" would likely be a sophisticated hedge fund investor, having read the testimony of Messrs. Fred Wilpon, Saul Katz and Arthur Friedman, it does not appear that they had such an understanding. Third, being on the board of a financial institution or owning an interest in a hedge fund does not result in securities trading sophistication. Many members of the boards of financial institutions are not themselves sophisticated market participants. Similarly, that an investor would leverage an investment, for example by making investments through a margin account, is of no consequence. Many retail customers have margin accounts.

Finally, ownership of a sports team is obviously irrelevant to stock market sophistication. As I explained in my initial report, the very fact that high net-worth individuals are successful in fields outside of the securities markets implies that they do not have time or expertise to manage their own investments. Therefore, the fact that the Sterling Defendants were successful in businesses unrelated to the securities industry does not support the conclusion that they were sophisticated investors.

No Defendant, based on the facts known to me, was even a financially sophisticated investor, much less an "institutional investor." My professional experience leads me to a conclusion completely contrary to that expressed in paragraph 26 of the Pomerantz Report, which says:

> "In my professional experience, investors with the sophistication of Sterling—similar to many high net worth individuals with which I have worked—behave like institutional investors, for example by performing quantitative and qualitative due diligence and by having a more robust and sophisticated understanding of the

> nature of financial markets, as well as understanding warning signs, i.e. red flags."

In my experience, high net-worth individuals that are not market professionals almost never do any "quantitative and qualitative due diligence." They pay, and rely on, institutional investors to do whatever is necessary to manage their investments, particularly where they have given their professional advisor discretion to trade for them.

Further, an institutional investor is, by definition, an institution that invests for other people, not a natural person that invests for himself. Institutional investors include pension funds, mutual funds, money managers, insurance companies, investment banks, and hedge funds—not high net-worth individuals or families. Institutional investors usually have extensive training in the financial markets and get paid for making securities investment decisions. Individual investors, even wealthy ones, who invest their own funds do not match the above profile of an institutional investor.

For that reason, Dr. Pomerantz's argument that the customs and practices of the investment management profession apply to some or all Defendants is, in my view, completely wrong. Pomerantz Report ¶ 27. The customs and practices of institutional investors are intended to set guidelines for investment professionals. Here, it is my understanding that Defendants were making investments *for themselves*, not for others, and not for compensation. They are entitled to invest on any basis they choose; they are not bound by any professional standards applicable to those who invest, as a profession and for compensation, for other people.

III. The Pomerantz Report's Conclusions as to Red Flags Are Either Incorrect or Inapplicable to Retail Investors

Finally, the so-called "red flags" are not the indicia of fraud that Dr. Pomerantz suggests. Pomerantz Report ¶ 27.

To begin with, the Report does not define "red flags." In the context of retail investing through a broker-dealer, I would define a "red flag" as information available to a retail investor that would justify a concern that the broker might be engaged in suspicious conduct. In my experience, none of the items on the Pomerantz list would be suspicious to a retail investor. For one thing, the Pomerantz list includes many items that no retail investor would know. It is highly unlikely that a single investor would know, for example, that BLMIS was trading at "impossible" volumes. Even if a retail investor were to think of such a thing, he would never have access to the necessary data regarding Madoff's trades on behalf of other investors in order to reach such a conclusion. In my opinion, it would take an expert, with records regarding the volume of the entirety of BLMIS's purported trading on behalf of all of his clients and records of total market volumes, to calculate that the volumes he was trading were impossible.

In addition, it is hard to conceive that a retail investor would have any reason to investigate the credentials of a broker's employees or those of his auditor—especially a broker so apparently successful and renowned as Mr. Madoff was. Rather, a retail investor would more likely rely on informal sources of information in selecting a broker-dealer, such as word-of-mouth recommendations from friends, family, and colleagues, the imprimatur of regulatory agencies such as the SEC, and historical rates of return. Retail customers investing their own money are entitled to rely on the fact that a broker is well-recommended, is registered with the SEC, produces regular reports, and makes payments as required. After a retail customer was sufficiently satisfied to invest, it would be unlikely that he would undertake additional diligence.

In my extensive experience, I have never encountered a retail investor who conducted continuous, complex and detailed investigations of his broker and how his broker managed trading in a discretionary account. Retail customers generally leave that supervision to the regulators.

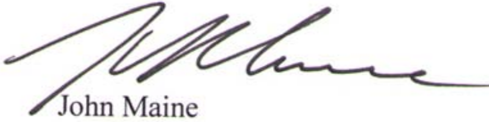
Further, the Pomerantz Report presents the list of supposed red flags as though all of these random items were simultaneously apparent to "Sterling." Of course there was no "Sterling." As I understand it, many individuals made their own independent investments, and none of them knew of all of the "red flags" at the time of any such investment, to the extent they knew of any. Listing random bits of data as if they were communicated at the same time, or as if they all existed in 1985, when I understand the first small investments were made, and suggesting that they were simultaneously known to any Defendant misrepresents the facts. Based on the information I have reviewed, those few of the supposed "red flags" that were communicated to one or another of the Defendants were communicated intermittently over a period of twenty-five years.

I have also read the report provided by Mr. Bruce G. Dubinsky. His report demonstrates that, even after Mr. Madoff confessed, a massive investigation was undertaken before details of the fraud became clear. That investigation disclosed that Mr. Madoff, and a number of others, engaged in strenuous efforts to hide the fraud, including the creation of enormous numbers of reports to customers and to regulators. Mr. Madoff was able to carry on his fraud for an almost incredible number of years because the mechanics of the fraud were so effective. No investor could have begun to replicate Mr. Dubinsky's efforts, and of course no investor would have had the head start provided by Mr. Madoff's confession.

IV. Conclusion

This report sets forth only a summary of the testimony I expect to provide at trial. I reserve the right to supplement or amend this report should additional information become available.

Respectfully submitted,



John Maine

December 13, 2011