MADOFF: THE LIABILITY OF THE SEC, FINRA, LARGE BANKS AND FUNDS, AND ACCOUNTANTS

June 16, 2010

PART I.

It has been obvious since shortly after December 11, 2008 that complete information and ideas about the Madoff scandal would not come out quickly, in a rushing torrent. Rather information, after the initial disclosures, would keep coming out slowly, over time. History and personal experience both teach that that is always the way things are with regard to major events (an idea recently reinforced upon me yet again by reading the latest book about "The Man Who Never Was," a story of the hoax regarding the invasion of Sicily in World War II that took decades to be revealed with something that at least *seems* close to completeness). One would like to know everything immediately, or at least quickly. But one knows it will take years, sometimes decades.

It does seem probable that a capital opportunity for the public -- and we the victims -- to learn a huge amount more about the Madoff matter in one fell swoop was missed when Judge Chin accepted a guilty plea from Madoff rather than requiring a trial at which evidence would have to be presented. But I suppose the government might claim that avoiding a trial -- and even more so in the case of Frank DiPascali -- enabled investigators to learn a lot more than they otherwise would have. While I am dubious, this is a question which will not be confidently answerable for several years yet.

In the meanwhile information, as expected, *has* been coming out, even if slowly. In particular, excellent sources of information and ideas seem to include the SEC Inspector General's two Reports on the Madoff case; the IG's two reports on the all too analogous Stanford scam; and complaints, among others, filed against J.P. Morgan Chase, against a money manager, now owned by the Bank of New York, called Ivy Asset Management, against Banco Santander, Price Waterhouse and subsidiaries or components of each, and against the SEC. There have also been two legal opinions of consequence (aside from Judge Lifland's opinion on net equity, which can be ignored for present purposes). Both involve governmental immunity under the Federal Tort Claims Act: one is in a California case asserting the SEC's negligence in Madoff, and the other is in a case involving the negligence of the Army Corps of Engineers that led to the destruction of New Orleans during Hurricane Katrina.

One can have high confidence in the information and ideas in the SEC Inspector General's reports, of course. Necessarily, one should not have as high a degree of confidence in the complaints, because they are adversary documents and are comprised of allegations rather than of truths shown by evidence at trial. Yet most -- even nearly all

-- of what they say has the ring of truth (and some of it, even much of it, is known to be true on the basis of prior information).

As for what is said in the two opinions, one is an intelligent assessment of what is necessitated by modern conditions. The other is simply imbecilic.

These various informational sources are relevant to several issues I would like to discuss in a two-installment post. The issues are important because they already are involved in major suits or are likely to be involved in suits that will be filed in future. One could write huge amounts about the involvements, about the relationships. I shall, however, try to confine myself by and large to only the most crucial points, which tend to get buried in the clouds of words appearing in the formal documents written by lawyers and judges.

Let us begin with the issue of the government's liability arising from the unbelievable negligence of the SEC. This is an issue on which, as is common in the legal profession, many lawyers waxed definitive when the Madoff case broke. Lawyers were quick to confidently say, on the basis of very little if any knowledge, that the government cannot be sued. The accuracy of this highly confident but knowledge-free reaction is open to serious doubt.

The problem arises because there is a medieval doctrine called sovereign immunity, under which the government cannot be sued. Though the doctrine is a relic of the days of kings and is wholly inconsistent with the rule of law, it is still followed in many instances. And, at bottom, it is this doctrine that accounts for the lawyerish knee-jerk reactions against the possibility of suit based on the SEC's horrendous conduct.

However, the doctrine of sovereign immunity has been waived by Congress in the Federal Tort Claims Act for matters that fall within that Act. Governmental negligence is one such matter, so under the waiver the government *can* be sued on account of the fantastic negligence of the SEC.

The waiver does not apply, however, if the matter involved is based on the policy of a given statute or statutes (like the various federal securities acts) and/or is a matter in which a government agency had discretion. The two ideas are often run together; there is no waiver, for example, if a governmental action, though it ultimately proved unsuccessful or even negligent, was within an agency's discretion in seeking to carry out the policy of a statute (such as the securities acts). So the question here is going to come down to whether, in conducting itself with horrible negligence, the SEC was acting within the policy of the securities laws and/or was exercising legitimate, permissible discretion in its enforcement of those laws.

One would think that, as the old saying goes, to put this question is to answer it. A powerful policy of the securities laws is to protect investors against fraud. It is utterly bizarre to argue that SEC personnel could be acting in accordance with the policy of the securities laws, rather than against such policy, by conducting themselves with such fantastic negligence that thousands or maybe even tens of thousands of people were defrauded out of their money instead of the fraud readily being caught and stopped by investigatory methods so simple that they are highly conventional -- methods such as (among many others) contacting counterparties to see if transactions had in fact occurred, contacting the Depository Trust Company to find out what securities Madoff held in his account there, contacting the NASD to see what trades he had engaged in, and determining (as various large funds did), whether there were enough options to cover his alleged strategy. It is correlatively and equally bizarre to say that SEC personnel had *discretion* to negligently fail to take even the most conventional investigatory steps and to thereby negligently thwart the deep seated securities law policy of stopping fraud.

Yet this bizarre claim is precisely what the government -- lacking anything else to say, I suppose -- is saying in the Madoff case. To be sure, it dresses up the claim in abstractions, such as saying that it has discretion on what to investigate and how deeply, etc. But at bottom it is saying (i) that it is free to be as negligent as it wishes, yet to remain immune from liability under the Federal Tort Claims Act even though the Act waives immunity for negligence, because (ii) everything it does ipso facto constitutes carrying out the policy of the securities laws and is a matter of discretion. As I shall come back to later in discussing the *Katrina* case, the government's claim would destroy the FTCA's waiver of immunity for negligence because, as the judge opined of the Corps of Engineers' argument in the *Katrina* case, the government's argument turns every single agency decision into one of policy-laden discretion no matter how negligent, no matter how contrary to established principles, and no matter how destructive to how many people whom the government is supposed to protect.

I find it an amazing thing that the judge in the California case against the SEC accepted the government's argument and dismissed the case, though he gave the plaintiffs permission to refile a complaint -- which says *something*, though I'm not sure what. The judge, as near as I can determine in various ways, seems to have a bad reputation for various reasons, but he is *not* thought stupid as far as I can tell. And he recognized that the SEC had acted with the most amazing incompetence. But he was angry at the plaintiffs, whom he thought (a) had done very insufficient work, and (b) had not presented any mandatory procedures or rules that SEC personnel had been obliged to but did not follow. (The lawyers who previously brought a much better known, still undecided, case in New York based on the SEC's actions also were angry at the California plaintiffs. In papers which the New Yorkers subsequently filed they accused the California plaintiffs of simply plagiarizing their complaint and of violating California court rules (as the California court had said), and also accused the SEC of underhanded conduct in not telling them of the California litigation while insisting on a so-called rocket docket (i.e., extremely quick) California decision which it could then present to the New York court.)

When the California plaintiffs filed their complaint, they said that SEC personnel had told them of an SEC manual, called "The SEC Policies, Procedures and Administrative Regulations," which was not public. Their idea regarding the non public manual seems to be that it may contain rules and policies which SEC personnel were required to but did not follow in the Madoff case. The SEC personnel, in other words, did *not* have discretion *not* to take investigative steps which they did not in fact take and which would have led to uncovering Madoff if they *had* been taken in accordance with the manual. Because the employees *lacked* discretion *not* to take such steps required by the manual, the SEC's negligent actions are not immunized under the FTCA.

That, as I say, is the theory. If I remember correctly, the whole issue regarding mandatory investigatory steps came to the fore when the New York lawyers initially brought their case. My memory is that they did so relatively early in the game and, in response to the smart alecks who had immediately opined that you can't sue the SEC, had replied that you *can* sue it if it had violated its own policies, and that they were going to seek access to its policies and manuals (which, I gather, they have not yet received -- which in itself can be considered suspicious). The questions of mandatory policies that SEC personnel may have violated then assumed, and still assumes, large importance, as illustrated by the California decision and proceedings.

It would be very nice, of course, if plaintiffs in New York, in California and in possible future cases were to receive discovery and to thereby learn that internal SEC manuals *required* steps that were not taken and that would have revealed Madoff's fraud had they *been* taken. But personally I think that the possibility of such policies has been way, way overemphasized. To me the existence of such policies, of such steps required by a manual, seems irrelevant. For even if there are no such policies or steps mandatorily required in some manual, still it *cannot* be the case that the SEC -- which was created to protect investors against fraud and on which Congress expected and desired investors to depend -- is free to be phenomenally negligent in a way that enables the longest and biggest fraud in history to continue unimpeded for years on end. There can be no statutory policy in favor of this, nor any agency discretion to do it. All to the contrary.

One should note in this regard that, in his reports in the Stanford case, the Inspector General said the exact opposite of any claim that the SEC was free to ignore the possibility of giant frauds. The IG's report in Stanford shows that the SEC was just as negligent there as in Madoff: its conduct was awful. Suffice to say that from 1997 onward, everyone in the SEC who dealt with the Stanford matter either knew Stanford was a Ponzi scheme or was at minimum aware that this was a real possibility. Yet for eleven or twelve years the SEC did *nothing*; as in Madoff it came up with one reason after another to do nothing though there were clear ways to stop the fraud, and it allowed a $7 billion Ponzi scheme to flourish. As the IG showed, the SEC had, indeed, a policy -- one relevant to Madoff too -- of usually *not* going after Ponzi schemes because they usually involved too much work to ferret out and prove. In other words, far from implementing a policy, with use of associated proper discretion, of enforcing Congress' statutory mandate against fraud, the SEC, as shown in the IG's report in Stanford, had a policy in contravention of Congress of *not* enforcing the bar against fraud when it came to huge Ponzi schemes that were ripping off people to the extent of billions upon billions of dollars. The SEC had no discretion to contravene Congress' antifraud policy, yet it did so and now claims, absurdly, that it was exercising proper discretion.

That the SEC was contravening Congress' antifraud policy was made clear by the Inspector General in his two reports in Stanford. Citing the canons of ethics governing the SEC, the IG said "The Commission's staff has the *obligation* to continuously and *diligently* examine and investigate instances of securities fraud." (Report of March 31, 2010, p. 10, emphases added. Report of June 19, 2009, p. 2, emphases added.) The IG also said, quoting the SEC's Regulations Concerning Conduct, that '"The [SEC] has been entrusted by Congress with the protection of the public interest in a highly significant area of our national economy.'" Report of March 30, 2010, p. 10. See also, Report of June 9, 2009, at p. 3 (There is a "serious duty" on the Commission and staff, because they are "entrusted [by Congress] with powers and duties of great social and economic importance to the American people.") The SEC has an "obligation" to act "diligently" against securities fraud, and must do so to protect "a highly significant area of our national economy" -- does that sound as if the SEC's own Inspector General thinks the SEC has policy discretion to be horribly negligent in failing to competently investigate and stop what probably are the two biggest Ponzi frauds in history? I don't *think* so, as it is sardonically said.

So the SEC's own Inspector General has no truck with the stupid claim that the SEC is free to act with horrible negligence against major securities fraud. The judge in the *Katrina* case also bashed -- "bashed" is the only word for it – the kinds of dumkopf arguments being made by the SEC, although he of course did it when the same arguments as are being made by the SEC for immunity from suit were made for the same purpose by the Corps of Engineers. (It is not wholly fortuitous, one thinks, that the same arguments for evading liability were made by the government in what may be the biggest municipal disaster in American history (*pace* Galveston) and in the biggest fraud-disaster in American history, both of which would have been avoided but for the kind of governmental negligence and incompetence that seem to have become *de rigueur* for the federal government).

Responding to the government's assertion that it was immune from liability for its terrible negligence in the *Katrina* case, the federal judge there (Stanwood R. Duval, Jr.) said that the government had the burden of proving that the discretionary exception to liability is applicable. For the discretionary exception to be applicable, an agency's choice of action (or inaction), said Judge Duval, must be an exercise of policy, which will not be the case if it violates some mandatory rule or is otherwise impermissible.

The government, said the judge, "seeks its cover in arguing that virtually every decision is one based on policy." But as said by the Fifth Circuit Court of Appeals, under such an interpretation '"virtually any decision to act or not to act could be characterized as a decision grounded in economic, social or public policy and, thus, exempt'" from liability. "[T]he exception" from liability for proper discretionary action would thereby "'swallo[w] the rule'" *against* immunity for negligence. Thus, "'in determining whether the discretionary function applies, *we examine the nature and quality of the activity to determine if it is the type that Congress sought to protect.*'" (Slip op. p. 100, emphasis added.)

In rejecting the government's arguments, Judge Duval accepted the plaintiffs assertions that "Ignoring safety and poor engineering are not policy," and that ignoring safety and indulging poor engineering were precisely what the Corps of Engineers had done. So there was no immunity from liability for negligence. "While the Corps maintains that all of its decisions were policy driven, when those decisions concern safety and engineering, this exception is not an absolute shield." (Slip op. p. 102.) They were not a shield here, where the Corps' actions were negligent, and where it had known that various corrective actions would be necessary, yet it had ignored this.

It was not permissible, ruled Judge Duval for the discretion exception to be used, as the Corps used it (and as the SEC is using it), "'to open the door to ex post rationalization by the Government.'" Having been guilty of "engineering blunders," "the Corps cannot mask these failures with the cloak of 'policy.'" A danger that will inevitably be created "cannot be ignored, and the safety of an entire metropolitan area cannot be compromised." *"Congress would never have meant to protect this kind of nonfeasance on the part of the very agency that is tasked with the protection of life and property."* (*Id.* at 111 (emphases added).)

Rather, what is protected, said Judge Duval via a quote from a leading Supreme Court case, are "'only governmental actions and decisions based *on considerations of public policy*,'" only actions '"*grounded in the social, economic, or political goals of the statute.'"* (*Id.*, p. 113 (first emphasis in original, second emphasis added.) Though "'*every inspection and maintenance decision* can be couched in terms of policy choices based on allocation of limited resources,'" this is not permissible lest the exception from liability for discretionary policy judgments be read too broadly. '"Cleaning up mold involves professional and scientific judgment . . . [and the crux of our holdings is that a failure to adhere to accepted professional standards is *not* susceptible to a policy analysis,'" i.e, cannot be immunized as an exercise of protected discretion. (*Id.*, p. 116, emphasis added.)

More than enough said. The *Katrina* decision makes clear that there should be no immunity for the government in the Madoff and Stanford cases on the ground that the SEC's horrible negligence in the two cases was an exercise of permissible discretion in accordance with the antifraud policy of the securities laws. As in the *Katrina* case, the government violated professional standards. As well, instead of protecting citizens as it was supposed to do under the statutory policy, the SEC opened the door to terrible injury to untold numbers of citizens. The government's argument would vitiate the FTCA's waiver of sovereign immunity in negligence cases because *every* investigatory and prosecutorial action and decision of the SEC, no matter how abysmal and negligent, would be turned into an exercise of permissible discretion. The SEC's negligent actions were *not* the kind of actions Congress intended to protect -- they were the exact opposite (as further shown, I note, by the furious Congressional outcry against the SEC when its misconduct regarding the disastrous Ponzi schemes came to light). And the government's arguments are merely ex post putative rationalizations to try to escape liability for a degree of negligence that boggles the mind.*

TO BE CONTINUED.

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* This posting represents the personal views of Lawrence R. Velvel. If you wish to comment on the post, on the general topic of the post, you can, if you wish, email me at Velvel@VelvelOnNationalAffairs.com.

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