UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re MANHATTAN INVESTMENT FUND LTD., et al. Debtors.	))))))	 00-10922 (BRL) 00-10921 (BRL) Jointly Administered
HELEN GREDD, Chapter 11 Trustee for MANHATTAN INVESTMENT FUND LTD., Appellee/Cross-Appellant vs. BEAR, STEARNS SECURITIES CORP. Appellant/Cross-Appellee	))))))))))))	 Adv. Pro. 01-02606 Civil Action No. 1:07-cv-02511-NRB Electronically Filed

BRIEF OF AMICUS CURIAE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
<u>IN SUPPORT OF REVERSAL</u>

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Introduction

The Securities Industry and Financial Markets Association ("SIFMA") is a trade association that brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that expand and improve markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests in the United States and globally. It has offices in New York, Washington, D.C., and London.

SIFMA has a strong interest in this case and is uniquely qualified to offer a broad securities industry perspective on the important issues before this Court. The Bankruptcy Court's January 9, 2007 opinion that is under review ("Opinion" or "Op.") ruled that Defendant Bear, Stearns Securities Corp. ("Bear Stearns") must pay more than $125 million that was deposited by an offshore hedge fund ("Manhattan Fund") into its own account and then lost in the course of pursuing its advertised short selling strategy during a rising market.

If upheld, the Bankruptcy Court's decision would significantly disrupt current precedent, standard industry practices, and the important balance the law has struck in order to allow millions of securities and commodities transactions to be processed quickly and cheaply every day by compelling securities clearing firms and prime brokers to undertake costly, time-consuming investigations into their accountholders' motives for issuing transaction instructions, resulting in firms either raising costs or withholding financing, thereby reducing market liquidity and, as a result, raising the cost of capital.

The law does not support or require that result. To the contrary, this Court, in its March 22, 2002 opinion dismissing Counts II and III of the Trustee's complaint, already has recognized the danger of impairing the efficiency of the securities markets if the Trustee's arguments were accepted:

> [B]rokerage houses . . . serve an important function for our securities markets by 'standing behind' trades. Well-capitalized brokers such as Bear, Stearns provide the often large amounts of cash and securities needed to complete securities transactions, thus permitting the securities market to function efficiently. [¶] If we were to accept the Trustee's arguments presented here, it would be riskier for brokers to stand behind customer trades and their protectively reactive actions would, no doubt, impair the efficiency of our securities markets.

Bear, Stearns Securities Corp. v. Gredd, 275 B.R. 190, 198 (S.D.N.Y. 2002) (Buchwald, J.) (citation omitted); see also Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890, 893 (7th Cir. 1988) ("Exposing financial intermediaries . . . to the risk of disgorging a 'fraudulent conveyance' . . . would lead them to take precautions, the costs of which would fall on solvent customers without significantly increasing the protection of creditors."). Those same principles are equally applicable with respect to Count I.[1]

The Bankruptcy Court's decision appears to be the first ever to hold that deposits into a customer's own account with a securities broker – in other words, simply moving cash between a customer's own accounts – are voidable under the Bankruptcy Code as fraudulent transfers. The holding is also inconsistent with the firmly established principle that a securities clearing firm and prime broker has no duty to inquire into the honesty and finances of its accountholders. See, e.g., U.C.C. § 8-102(a) cmt. 10 ("[I]t would impair rather than advance the interest of investors in having a sound and efficient securities clearance and settlement system to require intermediaries to investigate the propriety of the transactions they are processing."). Such firms do not exercise investment discretion, but instead provide incidental financing and – for just

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[1] If the Opinion were to be upheld, one would expect brokerage firms, upon adverse market movements, to become much quicker to liquidate accountholders' trading positions (particularly short positions) after (or in lieu of) issuing margin calls because, under this Court's prior ruling, liquidating trading positions following margin calls cannot be avoided as a fraudulent transfer, but, under the Bankruptcy Court's Opinion, depositing cash can be.

fractions of a penny per share – perform the ministerial "back office" functions necessary to clear and settle the trades. In imposing liability on Bear Stearns for its perceived "failure" to inquire into the Manhattan Fund's affairs, the Bankruptcy Court disregarded the long-recognized principle that a prime broker or clearing firm cannot be liable for merely processing transactions received from an authorized source (as Bear Stearns undisputedly did).[2] This principle has allowed the nation's financial industry to function effectively for decades, and creating an exception to this balance for bankruptcy proceedings would eviscerate it because bankruptcy filings often occur following adverse market movements, and trustees would attempt to secure recoveries from the brokerage firms.

The negative consequences of disrupting the nation's prime brokerage and clearing system as the Bankruptcy Court's decision would do should not be underestimated:

> The system routinely processes the multi-billion share trading volumes that characterize current securities markets. Without this highly efficient clearance and settlement system, modern securities markets simply could

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[2] See, e.g., U.C.C. § 8-503 cmt. 3 ("Rather than imposing duties to investigate, the general policy of the commercial law of the securities holding and transfer system has been to eliminate legal rules that might induce participants to conduct investigations of the authority of persons transferring securities on behalf of others for fear that they might be held liable for participating in a wrongful transfer."); Cromer Finance Ltd. v. Berger, 137 F. Supp. 2d 452, 470-72 (S.D.N.Y. 2001) (dismissing Manhattan Fund investors' claims that Bear Stearns aided and abetted Michael Berger by allowing him to continue trading on Bear Stearns' credit despite allegedly knowing of his Ponzi scheme and margin violations); Ross v. Bolton, 639 F. Supp. 323, 327 (S.D.N.Y. 1986) (dismissing claim against clearing firm for aiding and abetting fraud where complaint did not "specify what assistance [the clearing broker] rendered other than to continue to clear transactions when it 'knew or should have known'" that accountholder was engaging in fraud), aff'd, 904 F.2d 819 (2d Cir. 1990); see also Pension Cmte. of Univ. of Montreal Pension Plan v. Banc of America Securities, LLC, 446 F. Supp. 2d 163, 202-03 (S.D.N.Y. 2006) (prime broker owed plaintiff hedge fund investors no duty "to monitor, verify, or investigate the veracity of the information disseminated by" hedge fund manager); Lesavoy v. Lane, 304 F. Supp. 2d 520, 525, 526 (S.D.N.Y. 2004) (clearing firms owed no duty to accountholders' beneficiaries, as a broker "'has no duty to monitor a nondiscretionary account'" (quoting De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302 (2d Cir. 2002)), aff'd in part and rev'd in part on other grounds, 170 Fed. Appx. 721 (2d Cir. 2006); Stander v. Fin. Clearing & Servs. Corp., 730 F. Supp. 1282, 1286 (S.D.N.Y. 1990) ("It is clear that the simple providing of normal clearing services to a primary broker who is acting in violation of the law does not make out a case of aiding and abetting against the clearing broker.").

> not function. The structure and success of this system is no accident. Its regulatory contours, including the role and regulation of clearing brokers, have been shaped by federal regulatory actions and policies that have encouraged the non-duplicative allocation of operational and regulatory responsibilities for the ultimate benefit of investors. Such benefits have included lower commissions, fast and reliable clearance and settlement services, accurate and timely records of transactions, and secure custody of assets with well-capitalized clearing brokers.

Henry F. Minnerop, Clearing Arrangements, 58 Bus. Law. 917, 958 (2003) (emphasis added); see also Henry F. Minnerop, The Role and Regulation of Clearing Brokers, 48 Bus. Law. 841 (1993) ("Without the availability of the capital, technology, and expertise of clearing brokers, the smooth and reliable functioning of modern securities markets . . . would be impossible."). Those benefits would be seriously eroded if the Opinion, including its unprecedented fraudulent transfer and initial transferee holdings, were upheld, and would expose banks and brokerage firms to costly, time-consuming discovery even where there is no evidence of any actual knowledge or culpability because good faith is only a defense under 11 U.S.C. § 548 and bad faith therefore need not be pled affirmatively.

Nothing suggests that Congress intended to interfere with the efficient processes of the global securities markets when adopting and amending the Bankruptcy Code, and, in concluding otherwise, the Opinion misapplies bankruptcy law in at least two different areas. First, deposits into one's own account cannot be fraudulent transfers under 11 U.S.C. § 548(a) because they are economically neutral to the estate and do not place the assets beyond the reach of creditors. Second, clearing firms and prime brokers, as financial intermediaries, are not "initial transferees" of such deposits within the meaning of 11 U.S.C. § 550(a) because their functions are fundamentally clerical, routine, and nondiscretionary. Accordingly, as explained below, SIFMA respectfully requests that this Court reverse the Opinion.

Argument

I. DEPOSITS INTO ONE'S OWN ACCOUNT ARE NOT FRAUDULENT TRANSFERS.

As detailed below, it is well settled that a deposit of assets into one's own account cannot constitute a fraudulent transfer because it is economically neutral to the estate and does not place the assets beyond the reach of creditors. Indeed, the Bankruptcy Court's ruling that the Manhattan Fund's deposits into its Bear Stearns account were fraudulent transfers under 11 U.S.C. § 548(a)(1)(A) ignores this very Court's recognition that "the purpose of § 548(a)(1)(A) is to prevent the debtor from placing the assets beyond the reach of creditors by removing them from the estate with the intent to hinder, delay, or defraud his creditors" and its conclusion that "[a] transfer of property, even if made with fraudulent intent, that does not leave any creditor in a worse position than he would have been had the transfer never occurred, obviously does not offend the policy behind § 548(a)(1)(A)." Bear Stearns Securities Corp., 275 B.R. at 195 (internal quotation marks omitted). Likewise, the Ninth Circuit recently explained that a fraudulent transfer "is a transfer of some property interest with the object or effect of preventing creditors from reaching that interest to satisfy their claims or an act which has the effect of improperly placing assets beyond the reach of creditors." In re First Alliance Mortgage Co., 471 F.3d 977, 1008 (9th Cir. 2006); see also Melamed v. Lake County Nat'l Bank, 727 F.2d 1399, 1402 (6th Cir. 1984) (holding, under analogous provision of former Bankruptcy Act, that transfer to pay off portion of debt as to which creditor had valid security interest was not fraudulent transfer, regardless of intent, because it did not diminish assets of debtor available to creditors).

A deposit of funds into one's own account neither places the assets beyond the reach of creditors nor removes them from the estate, as any diminution in estate value results from the debtor's subsequent transactions or market movements, not the deposit itself. Indeed, if the accountholder were to petition for bankruptcy immediately after making the deposit, the estate would include the exact amount of assets as if the accountholder had petitioned without making the deposit. This is true whether the deposits were used to increase the account's assets or to reduce its secured debt to the firm. See, e.g., First Alliance Mortgage, 471 F.3d at 1008 ("repayments of fully secured obligations – where a transfer results in a dollar for dollar reduction in the debtor's liability – do not hinder, delay, or defraud creditors because the transfers do not put assets otherwise available in a bankruptcy distribution out of their reach"); see also Sharp Int'l Corp. v. State Street Bank and Trust Co., 281 B.R. 506, 522 (Bankr. E.D.N.Y. 2002) (debtor's payment to bank lender with funds debtor fraudulently obtained from new noteholder lenders did not hinder, delay, or defraud creditors because it "did not adversely affect [debtor's] financial condition or its ability to repay its other creditors, since it merely substituted [debtor's] obligation to the Noteholders for its obligation to" the bank), aff'd, 302 B.R. 760 (E.D.N.Y. 2003), aff'd, 403 F.3d 43 (2d Cir. 2005).

Accordingly, a deposit of funds to make margin payments following depreciation of a hedge fund's long securities positions does not create an avoidable transfer because the funds are used to pay off secured debt. Under the Opinion, however, if the hedge fund invests in short positions and adds to the collateral that supports those positions, then the payment is avoidable even though the economic result is the same as where the investor goes long rather than short. It cannot be that liability turns on whether the hedge fund manager was bullish or bearish. Thus, as a matter of law, the deposits at issue were not fraudulent transfers and cannot be avoided.[3]

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[3] The following hypothetical illustrates the point: an accountholder receives a margin call and deposits funds into its account; the account's securities positions then temporarily appreciate, and the accountholder withdraws the deposited funds (or their equivalent) and later petitions for bankruptcy within two years of the deposit. Under the Bankruptcy Court's reasoning, it is not clear that anything would prevent the absurd result of the trustee's recovering the deposit amount from the depository institution even though it had been withdrawn by the debtor. If, on the other hand, the trustee could not recover under that scenario, one must ask why that result should be any different where the account's positions do not appreciate or the accountholder otherwise does not withdraw the money.

II. FINANCIAL INSTITUTIONS THAT CREDIT DEPOSITS TO AN ACCOUNTHOLDER ARE NOT "INITIAL TRANSFEREES."

The Bankruptcy Court's holding that the Manhattan Fund's deposit of money into its account made Bear Stearns an "initial transferee" conflicts with the unanimous authority holding that a transfer of funds into a brokerage or bank account does not make the financial institution that holds the account an "initial transferee" under 11 U.S.C. § 550(a). See, e.g., In re Blinder, Robinson & Co., 162 B.R. 555, 562 (D. Colo. 1994) (financial services firm that "merely follow[ed] the instructions of shareholders in transferring funds held in the accounts it service[d]" was not an "initial transferee" of funds deposited by debtor); Kaiser Steel Resources, Inc. v. Jacobs (In re Kaiser Steel Corp.), 110 B.R. 514, 520-21 (D. Colo.) (transfer of funds into brokerage firm customers' accounts did not make brokerage firm "initial transferee"), aff'd on other grounds, 913 F.2d 846 (10th Cir. 1990); see also In re First Security Mortgage Co., 33 F.3d 42, 44 (10th Cir. 1994) (bank was not "initial transferee" of funds it received from debtor and placed in third party's account); Bonded Financial Svcs., 838 F.2d at 891, 893 (bank was not "initial transferee" of check it received from debtor for deposit into third party's account); In re Columbian Coffee Co., 75 B.R. 177, 179 (S.D. Fla. 1987) (bank was not "initial transferee" of wires it received from debtor and placed in third party's account). Nevertheless, the Bankruptcy Court concluded that Bear Stearns was an "initial transferee" of deposits into the Manhattan Fund's account because "[u]nder the terms of the Fund's Agreement with Bear Stearns, Bear Stearns had a security interest in any monies transferred; held the monies transferred as collateral for short sales; had the right to and did prohibit the Fund from withdrawing any of the monies transferred as long as any short position remained open; and had the right to and did use the monies transferred to purchase covering securities, with or without the Fund's consent." (Op. at *9.)[4]

[4] All page references to the Opinion are for its Westlaw citation: 2007 WL 60843.

That ruling conflicts with longstanding judicial precedent and the views of the United States Securities and Exchange Commission ("SEC"), and, if upheld, it would expose virtually every brokerage firm, bank, and other financial intermediary to becoming an "initial transferee." This is because the provisions of Bear Stearns' account agreement that the Opinion relies on for its holding are standard throughout the financial services industry. The court in Kaiser Steel Resources expressly considered and rejected the exact argument on which the Bankruptcy Court here relied:

> "Kaiser seeks to establish that Schwab exercised dominion over the funds paid to its customers by referencing certain provisions in Schwab's customer agreements which grant it a lien on assets held by Schwab . . . . As noted by the SEC, however, Commission regulations set strict requirements on a broker's use of customer funds to protect against misuse and abuse. See 17 C.F.R. 240.15c3-3. Schwab's customer agreements provide that the broker's lien and repossession rights are only to secure amounts due Schwab. There is no evidence that Schwab could arbitrarily apply customer funds for its own benefit."

Kaiser Steel Resources, 110 B.R. at 521. Indeed, as the SEC explained in its amicus brief in Kaiser Steel, the terms of brokerage industry agreements do not render the broker an "initial transferee" because those terms "are not significantly different from the rights that attorneys, banks, and clearing houses have at common law, and frequently by contract, to 'set off' or impose a lien upon a client's or customer's property for services rendered or fees earned[, and t]he existence of such rights has not proved an impediment in analogous cases." (R. 97 Ex. T at 16 n.19.)[5]

During the more than 17 years since the SEC made those observations and the court issued its ruling, prime brokers and clearing firms, including many of SIFMA's members, have relied on that clear precedent and continued to enter largely standardized agreements that grant

[5] References to the record on appeal are abbreviated "R. [Bankruptcy Court docket number]," as listed in Part I of Bear, Stearns Securities Corp.'s Designation of Record and Statement of Issues on Appeal (dated Mar. 12, 2007; entered Mar. 27, 2007).

them security interests in the assets they hold and permit them to retain and apply such assets to the extent necessary to protect their rights, while generally leaving all investment discretion to their accountholders. In fact, SIFMA's model Agreement for Prime Brokerage Clearance Services includes the same provisions that, in the Bankruptcy Court's view, made Bear Stearns an "initial transferee."[6] To hold now that such provisions confer the level of "dominion and control" to cause a financial institution to become an "initial transferee" rather than a "mere conduit" would turn on their head the expectations created by two decades of uniform case law. Further, an affirmance of the Opinion would expose prime brokers and clearing firms to potentially hundreds of millions of dollars in disproportionate liability should their accountholders file for bankruptcy, disrupt standard industry practices, significantly increase the costs of processing trades, wires, and other financial transactions, and concomitantly diminish the efficiency and liquidity of the markets.

The Second Circuit has never held that a financial services firm becomes an "initial transferee" simply by accepting a deposit and retaining some ability to protect its rights. Rather, the test is whether the functions the firm performs were routine and nondiscretionary. Ten years ago, the Court of Appeals held that an insurance broker was a "mere conduit" with respect to premium payments it received from a debtor policyholder where the broker, which was entitled to retain a commission, otherwise "had no discretion or authority to do anything else but transmit the money, which is just what it did . . . [as] an ordinary and routine financial transaction for an agency in [its] industry," and the court explained that "[a] commercial entity that, in the ordinary course of its business, acts as a mere conduit for funds and performs that role consistent with its

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6 (See, e.g., Op. at *9; R. 97 Ex. U ¶¶ 3, 5, 17; SIFMA, "Agreement for Prime Brokerage Clearance Services," (Rev. 3/08/06) ¶¶ 10, 11, 14, available at <http://www.sia.com/standard_forms/pdf/primeForm151FinalVer.pdf>. (For the Court's convenience, a copy of the model agreement is submitted herewith as an attachment to the Declaration of Eric A. Bensky.))

contractual undertaking in respect of the challenged transaction is not an initial transferee within the meaning of § 550(a)(1)." In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, 130 F.3d 52, 55, 59 (2d Cir. 1997).

Clearing firms and prime brokers such as Bear Stearns in this case perform back office responsibilities that are paradigmatically ordinary, routine, and nondiscretionary, while the sometimes discretionary front office functions are allocated to an "introducing" broker. Here, the Manhattan Fund's introducing broker with responsibility for front office functions was Financial Asset Management. (See, e.g., Op. at *12.) Far from exercising investment discretion, prime brokers and clearing firms perform the clerical processing functions of crediting accounts, debiting accounts, clearing and settling trades, and in some cases financing and/or executing trades as instructed by the accountholders or their introducing brokers.[7] The lack of discretion and dominion over deposited funds is exemplified by the statutory, regulatory, and common law that prohibits the firms from using such assets for their own purposes, and is not changed by the fact that the broker retains a secured interest in the deposit. For example, uniform state law codifies the "ordinary understanding that securities that a firm holds for its customers are not general assets of the firm subject to the claims of creditors." U.C.C. § 8-503 cmt. 1; see also U.C.C. § 8-503(a). Likewise, SEC rules bar broker-dealers from using customer funds for the broker-dealers' own purposes. See 17 C.F.R. § 240.15c3-3(e)(2) & § 240.15c3-3a (making it unlawful for broker-dealers to use, inter alia, credit balances in customer accounts for broker-

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7 See, e.g., Dillon v. Militano, 731 F. Supp. 634, 636 (S.D.N.Y. 1990) (A clearing firm "handles the mechanical, record-settlement functions related to the clearance and settlement of various transactions in the accounts of the introducing firm's customers." (internal quotation marks omitted)); The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Before the Fin. Servs. Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enter., U.S. House of Representatives, 108th Cong. 10 (2003) (statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission) (A prime broker "clears and finances the customer trades executed by one or more executing broker-dealers at the behest of the customer[, and] . . . is responsible for all applicable margin and Regulation T requirements for the customer.").

dealers' general purposes). Finally, broker-dealers that do use customer funds for their own purposes can be held liable for conversion. See, e.g., Schruefer v. Winthorpe Grant, Inc., No. 99 Civ. 9365, 2003 WL 1108933, at *5 (S.D.N.Y. Mar. 12, 2003) (granting plaintiff judgment on conversion claim where defendant broker-dealer and its personnel, instead of investing money as instructed, withdrew and redirected funds from plaintiff's account for defendants' use).

Thus, the fact that prime brokers and clearing firms have certain rights to protect their positions under their standard contracts with their clients does not convert the nature of the accounts from nondiscretionary to discretionary. See, e.g., Kaiser Steel Resources, 110 B.R. at 521. Accordingly, such industry-wide contractual rights do not justify the Bankruptcy Court's unprecedented ruling that deposits into a brokerage account confer "initial transferee" status on the brokerage firm.

Conclusion

The nation's financial markets depend on the ability of clearing firms and prime brokers to process enormous quantities and volumes of transactions quickly and cheaply. Judicial, legislative, and regulatory authority establishes that the firms are not to be slowed and burdened by a requirement to investigate their customers' motives in issuing instructions. Indeed, three industry associations that collectively represent more than 1400 members in the equity, debt, and derivatives markets are submitting amicus briefs here because an affirmance of the Bankruptcy Court's unprecedented interpretation of the Bankruptcy Code would disrupt the economic efficiencies and the standard industry practices that currently prevail and expose financial firms to large and disproportionate liability for performing routine, ministerial, back office functions of processing transactions received from an authorized party. In the interests of its 650 members of the financial services industry, SIFMA respectfully requests that this Court reverse the Opinion and preserve the order that heretofore has allowed the country's markets to function smoothly and efficiently.

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Respectfully Submitted,

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