FINRA DISPUTE RESOLUTION, INC.

Financial Trust Company, Inc. and The C.O.U.Q. Foundation, Inc.,	:	
Claimants,	:	
	:	FINRA No. 09-979
v.	:	
	:	AMENDED STATEMENT OF ANSWER
The Bear Stearns Companies, Bear Stearns & Co., Bear Stearns Asset Management, and Warren Spector,	:	
Respondents.	:	

Pursuant to Rule 12303 of the Code of Arbitration Procedure for Customer Disputes, Respondent Warren Spector, by his attorneys Wachtell, Lipton, Rosen & Katz, respectfully submits this Amended Statement of Answer in response to Claimants' Amended Statement of Claim.[1]

PRELIMINARY STATEMENT

Claimants in this action, Financial Trust Company, Inc. ("FTC") and The C.O.U.Q. Foundation, Inc. ("COUQ") (collectively, "Claimants"), are retail investors managed by Jeffrey Epstein. Epstein, a very wealthy individual and a former partner at Bear, Stearns & Co., Inc. ("Bear Stearns"), is a long-standing customer of Bear Stearns and a sophisticated investor who has invested with Bear Stearns, both personally and on behalf of his clients, for over 25 years. Since his departure from Bear Stearns in 1981, he has also maintained a close personal relationship with Jimmy Cayne, Bear Stearns' former Chairman and CEO. Until the

[1] Respondent hereby incorporates by reference the Statement of Answer submitted by Respondents The Bear Stearns Companies, Inc., Bear Stearns & Co., Inc., and Bear Stearns Asset Management, submitted December 4, 2009, as if fully set forth herein.

global credit crisis of 2007, Epstein's investments with Bear Stearns had been successful and he had enjoyed years of positive returns.

Following the overall market collapse precipitated by the credit crisis of 2007, Epstein, like most investors, sustained investment losses. In this action, in addition to asserting claims against the company, Epstein seeks to pin responsibility for certain hedge fund losses on a single individual — Warren Spector, the former President and co-Chief Operating Officer of Bear Stearns. That either Bear Stearns or any single individual could be responsible for Epstein's losses when investors and regulators around the globe are still grappling with the question of how the credit market implosion caused a global financial meltdown is, of course, implausible.

In Epstein's haste to find a scapegoat, he conspicuously omits two critical facts from his Amended Statement of Claim. First, Warren Spector did not manage the funds at issue within Bear Stearns Asset Management ("BSAM"). He was not responsible for marketing the Funds (defined herein) or for the solicitation of investors, and he was several reporting lines removed from the valuation, oversight and monitoring of the Funds. Epstein's decision to single out Spector as the responsible individual is puzzling at best. Second, Epstein's narrative ignores that, prior to investing with BSAM, he received extensive written materials marketing the Funds, which disclosed in detail the risks associated with these highly leveraged, highly illiquid investments. He signed multiple documents affirming that he was aware of and understood the strategy and associated risks. Now that he has realized losses as a result of this particular investment, however, Epstein asserts — incredibly, given his sophistication and success in this field — that his investment decisions were guided not by the comprehensive Private Placement Memoranda he received from BSAM, but by a single unsubstantiated conversation that he

purportedly had with Spector in the summer of 2006. Epstein further claims that his investment decisions in the spring of 2007 were based entirely upon a series of alleged conversations with Spector. As Epstein well knew, however, Spector was neither the manager of the Funds nor the direct supervisor of those managers.

In addition to these conspicuous omissions, Epstein's Amended Statement of Claim is replete with blatantly false factual assertions and illogical, inconsistent allegations. For example, among other misstatements:

- Epstein alleges that the High Grade Fund was experiencing losses in 2006, a time when it was actually quite profitable.
- Epstein alleges that the value of the High Grade Fund's portfolio was artificially inflated prior to 2006, yet fails to articulate how, or why — which is unsurprising given that there has been no finding that the valuation of the High Grade Fund in 2006 was inaccurate.
- Epstein alleges that Spector played a role in valuing the Funds' portfolio. In fact, Spector had no involvement whatsoever in that process.
- Finally, in a desperate attempt to invent some compelling motive for Spector's alleged wrongdoing, Epstein asserts that a majority of Spector's compensation was directly tied to the performance of the Funds, which allegedly incentivized him to manipulate the prices of the Funds' holdings. This allegation is simply untrue.

As will be established at the hearing, Epstein's claims are unsupported by the facts and deficient as a matter of law. Epstein is simply a disgruntled investor who, like so many others, lost money when the credit markets collapsed. But his losses were not caused by any wrongful or fraudulent acts by Bear Stearns as an institution or by Warren Spector individually. Epstein was a sophisticated investor who sought out the potentially high returns offered by highly leveraged hedge funds and who fully understood the attendant risks; that these risks became a reality in the perfect storm that hit the financial markets in 2007 does not provide a

legal basis to hold Bear Stearns responsible for these losses — much less to hold Mr. Spector personally responsible.

FACTS

A. Jeffrey Epstein's Long History with Bear Stearns.

According to the Amended Statement of Claim (cited herein as "Am. St. Claim"), Jeffrey Epstein joined Bear Stearns as a trader in 1977. He left the company four years later, but he has for many years maintained close personal and professional relationships with both Alan Greenberg, former Chairman of the Board, and Jimmy Cayne, former long-time CEO and Epstein's mentor. Epstein invested millions of both his own money and his clients' money with Bear Stearns following his departure from the firm over 25 years ago.

Sometime in the mid-1990s, Cayne introduced Spector to Epstein, and they crossed paths socially a few times in the ensuing decade. As a result of his relationship with Cayne and his enormous personal wealth, Epstein was considered a VIP client at Bear Stearns; accordingly, Spector occasionally had brief conversations with Epstein about business with Bear Stearns. As with any VIP client, Spector and other members of senior management made themselves accessible and responsive. Thus, although Spector was not Epstein's regular contact within Private Client Services, when Epstein reached out to him, Spector attempted to contact the appropriate traders, brokers, or managers to respond to Epstein's questions. In addition, following Epstein's initial investments in BSAM hedge funds, when new opportunities at BSAM arose, BSAM personnel occasionally asked Spector to bring them to Epstein's attention. However, Spector had no knowledge or involvement regarding the amount or nature of most of Epstein's many transactions with Bear Stearns. In addition to their sporadic phone calls relating

to Bear Stearns, Epstein and Spector were occasionally in one another's presence at social functions and had the opportunity to speak regarding personal topics.

In stark contrast to the portrait of an ongoing advisory relationship that Epstein attempts to paint, Spector's contact with Epstein was infrequent and irregular. And contrary to Epstein's assertion that Spector was officially assigned to serve in the "role of liaison between Bear Stearns and Eptsein" (Am. St. Claim ¶ 19), others regularly served in that capacity. Indeed, in a publicly-filed Complaint in a separate action in the United States District Court for the District of the Virgin Islands, Epstein alleges repeatedly that "Cayne and Greenberg" — *not Spector* — were his primary points of contact at Bear Stearns.[2]

When Spector did speak with Epstein, the conversations generally were cursory and involved almost no substantive dialogue. Given that Spector's position at Bear Stearns did not involve investor contact or portfolio management, this infrequency is unsurprising. Indeed, during the time Epstein claims to have been relying on Spector for investment advice,[3] Spector was co-President and co-COO of Bear Stearns and was involved in a massive reorganization of the company's sales and trading business. This process of restructuring the groups within sales and trading accounted for a significant portion of Spector's time, and he was primarily focused

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[2] Epstein asserts, for example, that he "regularly communicated directly with the most senior management of Bear Stearns"; that in assessing investment opportunities he relied on "personal discussions with Bear Stearns' senior management, including *Cayne and Greenberg*, concerning, without limitation, Bear Stearns' liquidity and capital reserves, accounting policies and valuation procedures"; that he had "numerous telephone conversations about [Bear Stearns' exposure to the U.S. residential mortgage market] *with Cayne and Greenberg*"; and that he discussed the impact of "the Enhanced Fund's high leverage and resulting liquidity issues" *with Cayne*. *See* Complaint, *Fin. Trust Co., Inc.* v. *The Bear Stearns Cos. Inc.*, Civ. No. 09-0106 (D.V.I. Aug. 5, 2009), ¶¶ 17, 23, 26, 39 (emphases added) (attached hereto as Exhibit H).

[3] As Epstein himself admits, his investments with Bear Stearns were also guided by the "assurances, advice and representations" of "*other executives at the highest levels of Bear Stearns' management.*" Am. St. Claim ¶ 19 (emphasis added).

on big-picture issues of strategy and growth. The day-to-day management and oversight of certain hedge funds within the asset management group — which was itself just a small component of Spector's overall responsibilities, and an even smaller component of Bear Stearns as a whole — were several steps below his level of responsibility.

With respect to the two hedge funds central to Epstein's claim — the Bear Stearns High-Grade Structured Credit Strategies, L.P. (the "High Grade Fund") and the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Fund, L.P. (the "Enhanced Fund") (collectively, the "Funds") — Epstein fundamentally misapprehends the nature of Spector's role and responsibilities. Spector neither personally "oversaw the management of the Funds" nor represented that he oversaw the Funds. Am. St. Claim ¶ 16. Indeed, Epstein admits as much, conceding that Ralph Cioffi and Matthew Tannin — not Spector — were "[t]he two Bear Stearns executives most directly involved in managing the funds." Am. St. Claim ¶ 9. Epstein's assertion that the portfolio managers for the Funds reported directly to Spector is also false, as is his claim that Spector was involved in valuing the Funds' portfolios. The portfolio managers' reporting lines existed within BSAM, and BSAM pricing personnel were responsible for valuation and accounting. Nor was Spector responsible for developing Bear Stearns' hedge fund business — it had been growing for many years and was the focus of several executives within BSAM. Am. St. Claim ¶ 16. Finally, Spector was neither "Bear Stearns' risk manager" nor "integrally responsible for the [Enhanced Fund's] risk management." Am. St. Claim ¶¶ 8-9. Risk management was carried out at both the BSAM level and at the level of the Funds, and BSAM staff monitored risk controls with respect to all funds — Spector was not involved. Contrary to Epstein's slew of misrepresentations, Spector in reality had very limited involvement in the creation, marketing, or management of the Funds.

B. Epstein Invests in the High Grade Fund.

In late 2003, Epstein was provided with the Private Placement Memorandum ("PPM") for the High Grade Fund (Exhibit A) by someone within BSAM's Hedge Fund Services. According to the PPM, the High Grade Fund intended to invest "through leveraged investments in investment-grade structured finance securities with an emphasis on triple-A and double-A rated collateralized debt obligations," through investments "in other structured finance assets including asset-backed securities, mortgage-backed securities and global structured asset securitizations," and generally with "a Net Leverage[] of its investments of 10 to 1." Ex. A at 1. Although the High Grade Fund's high leverage allowed it to increase its returns substantially, so too did it increase the concomitant risk. Indeed, as set forth repeatedly in the PPM, investment in the High Grade Fund "involve[d] a substantial risk of loss." *Id.* at i. More specifically, the PPM set forth in detail the "Risk Factors" associated with an investment in the High Grade Fund including, among others:

- **Total Loss**: "[T]here is a risk that an investment in the [High Grade Fund] will be lost entirely or in part." Ex. A at 10.

- **Leverage**: "The [High Grade Fund] invests on a highly leveraged basis. . . . [A]ny event which adversely affects the value of an investment would be magnified to the extent leverage is utilized. The cumulative effect of the use of leverage with respect to any investments in a market that moves adversely to such investments could result in a substantial loss which would be greater than if the investments were not leveraged." *Id.*

- **Illiquidity**: "Securities purchased by the [High Grade Fund] may lack a liquid trading market, which may result in the inability of the [High Grade Fund] to sell any such security or other investment or to close out a transaction involving a non-U.S. currency or the sale of an option, thereby forcing the [High Grade Fund] to incur potentially unlimited losses." *Id.* at 14.

- **Hedging Transactions**: "[W]ith respect to certain investment positions, the [High Grade Fund] may not be sufficiently hedged against market fluctuations, in which case an investment position could result in a loss greater

than if the [High Grade Fund] had been sufficiently hedged with respect to such position." *Id.*

In addition, the section entitled "Risk Factors" opened with a warning that "There is a high risk associated with an investment in the [High Grade Fund]" and concluded similarly:

> INTERESTS ARE SPECULATIVE AND INVOLVE A HIGH DEGREE OF RISK. THEY ARE SUITABLE ONLY FOR PERSONS WHO CAN AFFORD TO LOSE THEIR ENTIRE INVESTMENT. THE FOREGOING LIST OF RISK FACTORS DOES NOT PURPORT TO BE A COMPLETE EXPLANATION OF THE RISKS INVOLVED IN THIS OFFERING.

Id. at 10, 17 (capitalization in original). Thus, prior to investing in the High Grade Fund, Epstein was well aware of its high-risk investment strategy and reliance on a significant amount of leverage. His assertion in the Amended Statement of Claim that he believed the High Grade Fund was designed to "provide modest, safe and steady returns" (Am. St. Claim ¶ 20) is not credible in the least and is, of course, flatly contradicted by the documents Epstein reviewed prior to subscribing and that he himself cites in his Amended Statement of Claim. A sophisticated investor with decades of experience, Epstein clearly understood the risks associated with a large investment in the High Grade Fund.

Similarly, Epstein's claim that the High Grade Fund's investment in Collateralized Debt Obligations ("CDOs") was "[c]ontrary to initial representations made to investors" (Am. St. Claim ¶ 23) is belied by specific representations in the PPM. The very premise of the High Grade Fund was that it was a highly leveraged investment vehicle that would invest mainly in highly rated asset-backed securities. This strategy was disclosed in the PPM in detail:

- **CDO Investment Related Risks**: "CDOs are subject to credit, liquidity and interest rate risks. In particular, investment-grade CDOs will have greater liquidity risk than investment grade sovereign or corporate bonds. There is no established, liquid secondary market for many of the CDO securities the [High

> Grade Fund] may purchase. The lack of such an established, liquid secondary market may have an adverse effect on the market value of such CDO securities. . . " Ex. A at 11.

Following his review of the PPM, on January 23, 2004, Epstein — in his capacity as President of FTC — signed a Subscription Agreement and invested $15 million in the High Grade Fund (Exhibit B). By signing that Subscription Agreement, Epstein represented as follows:

> The Investor has received and read a copy of the [PPM] . . . . The Investor acknowledges that in making a decision to subscribe for an Interest the Investor has ***relied solely upon*** the [PPM], the [High Grade Fund's] Documents, the most recent annual report and accounts of the [High Grade Fund] (if any) and (where applicable) the most recent unaudited monthly report, and independent investigations made by the Investor.
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> The Investor has carefully reviewed and understands the various risks of an investment in the [High Grade Fund], including those summarized under "Risk Factors" and described in greater detail elsewhere in the [PPM]; the undersigned understands that an investment in the [High Grade Fund] is speculative and the undersigned can afford to bear the risks of an investment in the [High Grade Fund], including the risk of losing the undersigned's entire investment. The undersigned understands that the Interests are illiquid.

Ex. B at 11-12 (emphasis added). Epstein also reaffirmed that he could "afford a complete loss of the investment" and was "aware that . . . there are substantial risks of loss of investment incidental to the purchase of the Interest, including those summarized in the [PPM]." *Id.* at 12.

Epstein's contemporaneous affirmations in his Subscription Agreement undercut his claims that his investment in the High Grade Fund was motivated by a desire for safe and steady returns. This after-the-fact characterization, clearly colored by the losses he sustained as a result of the credit crisis and the High Grade Fund's collapse, is entirely undercut by his affirmations at the time of his subscription.

C. Epstein Invests in the Enhanced Fund.

For several years following its creation, the High Grade Fund generated exceptional returns. During the two and one-half years Epstein was invested in the High Grade Fund, for example, it recorded returns of over 25%. Nevertheless, certain investors sought even higher returns through a more highly leveraged fund. Thus, in 2006, BSAM created the Enhanced Fund. Around this time, in discussing the types of investments he was seeking, Epstein informed Spector that he was interested only in investments with returns of 25% or higher. Epstein stated that he was *not* looking for safe, low volatility opportunities but, rather, was interested in high risk and high return.

All High Grade Fund investors were contacted by someone within Hedge Fund Services, informed about the launch of the Enhanced Fund, provided with the marketing and offering materials, and given the opportunity to move their investments from the High Grade Fund to the Enhanced Fund. The Enhanced Fund was considered an attractive investment opportunity. Thus, consistent with Bear Stearns' practice, Spector personally contacted certain High Grade Fund investors, including Epstein, to make them aware of the Enhanced Fund.

As a business matter, it made little difference to senior management whether a given investor subscribed to the High Grade Fund or the Enhanced Fund. Epstein, however, asserts that Spector and others were motivated to move investors from the High Grade Fund to the Enhanced Fund. Am. St. Claim ¶ 37. Relying on the false premise that the High Grade Fund was foundering as early as 2006, Epstein claims that the Enhanced Fund was conceived and created for the specific purpose of masking these alleged "problems" in the High Grade Fund's portfolio — problems that, although nonexistent, form the entire basis of Epstein's allegations regarding Respondents' motivation for "[c]onvincing as many investors as possible to transfer from the High Grade Fund to the Enhanced Fund." Am. St. Claim ¶ 37. No part of Epstein's

theory holds water. The High Grade Fund was profitable and performing well, and Epstein's attempts to invent a series of motives based on assertions to the contrary are unsuccessful.

Epstein first claims that the High Grade Fund was "deteriorating" and that Spector knew about and concealed this alleged deterioration to encourage investment in the Enhanced Fund. The incontrovertible facts, however, are that as of July 2006, the High Grade Fund had yet to record a loss and was proving extremely profitable. Spector had no reason to distrust the High Grade Fund's results, and Epstein's conclusory allegations that the High Grade Fund prices were "fictitious" are wholly unsubstantiated and intended solely, it appears, to provide support for his theory that Spector and others had a compelling incentive to start the Enhanced Fund. According to Epstein, by creating a second fund, Bear Stearns was "better able to self-deal" by increasing trading volume to, in turn, maintain allegedly fictitious prices. Am. St. Claim ¶ 6. This allegation, however, rests upon the same faulty assumption underlying Epstein's entire claim — that the High Grade Fund's prices were massively inflated as of the summer of 2006. To the contrary, the High Grade Fund's prices were the result of a diligent pricing process and committee approval, and Respondent Spector is aware of no evidence suggesting these prices were in any way inaccurate. Indeed, Epstein appears to have invented this "fact" for the sole purpose of tying together the inconsistent and insufficient allegations set forth in his initial Statement of Claim.

Epstein further attacks the High Grade Fund by alleging that it suffered from a serious liquidity problem due to its cessation, in 2006, of trading in the CDO market between BSAM and Bear Stearns itself. Because of this alleged liquidity crisis, his story continues, the High Grade Fund needed a partner fund with the ability to borrow more against its assets. These assertions are inaccurate. The High Grade Fund traded with multiple counterparties, and Bear

Stearns was just one of its many counterparties. Because it had plenty of other counterparties with which to trade, the decision to halt principal trades temporarily neither harmed the Funds nor precipitated a liquidity crisis.[4] There was no liquidity crisis in the summer of 2006, and Epstein's attempt to fabricate one — in a further attempt to engineer a motive guiding the creation of the Enhanced Fund at this time — falls flat.[5]

Taking a different tack, Epstein also alleges that the structure of Spector's compensation served as motivation for him to convince investors to roll over into the Enhanced Fund. According to Epstein, "the majority of Spector's compensation was tied to the growth and purported performance of these Funds." Am. St. Claim ¶ 16. Epstein's assertion is based on nothing more than supposition and is completely backwards. Spector's compensation — in 2007 and for many years prior — was calculated pursuant to a formula established by the Bear Stearns Board and was a percentage of the overall net profits of the firm. His compensation was based solely and exclusively on the profitability of the corporation as a whole; this formula did not vary from year to year; and it was related to the performance of various hedge funds only insofar as BSAM, as a small division of Bear Stearns, contributed to the overall profitability of Bear Stearns. As a factual matter, BSAM — in comparison to Fixed Income, Equities, or other divisions within Bear Stearns — had the least impact on the corporation's bottom line. There was absolutely nothing in the mathematical formula establishing Spector's compensation that linked his salary or bonus in any specific or general way to the performance of two hedge funds

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[4] In any event, a liquidity crisis is caused not by the loss of a particular counterparty, but by the inability to borrow capital. Incidentally, to the best of Spector's recollection, in 2006 the High Grade Fund borrowed only a very small percentage of its capital from Bear Stearns.

[5] It is worth noting that Spector himself was involved in the decision to halt principal trading. Far from being hampered by this change, Spector was in fact one of the members of senior management who made the decision in the first place.

within Bear Stearns Asset Management, or to the performance of the Enhanced Fund in particular.[6]

Not one of these attempts to invent a motive for Spector's alleged solicitation is based in fact. The truth, as Epstein well knows — and as set forth in the publicly filed offering documents — is that the Enhanced Fund was a new, highly risky and highly leveraged fund, which was viewed by many as an excellent investment opportunity and which was made available to every High Grade investor. Accordingly, Epstein was provided with the PPM for the Enhanced Fund dated June 30, 2006 (Exhibit C).

As with the High Grade Fund, the materials provided to investors in connection with the Enhanced Fund offered a detailed description of its investment strategy and the associated risks. According to the PPM, the Enhanced Fund's "primary objective [was] to seek high current income and capital appreciation relative to LIBOR" by investing "synthetically in the Master Fund generally on a 2.75 times leveraged basis." *Id.* at 12. The Master Fund, in turn, sought "leveraged investments in investment-grade structured finance securities," *id.*, and planned to operate generally at a 10-to-1 net leverage. *Id.* at 1. The Enhanced Fund's PPM also highlighted that its strategy differed from that of the High Grade Fund:

> BSAM also operates [the High Grade Fund], an investment vehicle which has an investment strategy similar to that of the Master Fund, but is not subject to the same investment restrictions or considerations relating to the additional leverage provided under the Leverage Instrument.

Id. at 4.

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[6] Furthermore, Epstein's assertion that Spector was involved in "an internal conflict," in 2007, over his "personal compensation" is without basis. Am. St. Claim ¶ 9. At no time in 2007 — or at any time during the life of the Enhanced Fund, for that matter — was Spector involved in any dispute, internal or otherwise, relating to his compensation. Like Epstein's other fabrications, this assertion is a transparent attempt to fabricate a motive for the otherwise unsupported allegations of fraud.

The risks associated with such a highly leveraged fund are of course substantial and were spelled out in detail in the PPM:

- **Potential Loss of Investment**: "[T]here is a risk that an investment in the [Enhanced Fund] will be lost entirely or in part." *Id.* at 17.

- **Leverage**: Because the Enhanced Fund invests through leveraged total return swaps which provide it with a "2.5 to 2.75 times leveraged exposure to the Master Fund" and because "[t]he Master Fund itself invests on a highly leveraged basis," "any event which adversely affects the value of an investment would be magnified to the extent leverage is utilized. The cumulative effect of the use of leverage with respect to any investments in a market that moves adversely to such investments could result in a substantial loss which would be greater than if the investments were not leveraged." *Id.*

- **Repackaging Vehicle Securities**: "Investors must consider with particular care the risks of leverage in Repackaging Vehicle Junior Interests because, although the use of leverage creates an opportunity for substantial returns for the Master Fund on the Repackaging Vehicle Junior Interests, it increases substantially the likelihood that the Master Fund could lose its entire investment in Repackaging Vehicle Junior Interests if the pool of collateral held by the relevant Repackaging Vehicle is adversely affected by market developments." *Id.* at 18.

- **CDO Investment Related Risks**: "CDOs are subject to credit, liquidity and interest rate risks. In particular, investment-grade CDOs will have greater liquidity risk than investment grade sovereign or corporate bonds. There is no established, liquid secondary market for many of the CDO securities the [Enhanced Fund] may purchase. The lack of such an established, liquid secondary market may have an adverse effect on the market value of such CDO securities. . . " *Id.* at 19.

- **Lower-rated and Unrated Securities**: "While the primary focus of the Master Fund will be on highly-rated debt securities (AA- or higher), up to 10% of the investment portfolio . . . may be invested in lower-rated investment grade, below investment grade or unrated securities. As the Master Fund's portfolio is leveraged, such holdings may be equal to a substantial amount of the Master Fund's Net Asset Value. In fact, if the Master Fund employs Net Leverage of ten-times its Net Asset Value, the value of such securities may equal up to 100% of investors' capital. A substantial portion of the Limited Partners' investment may therefore be exposed to the credit risks and potentially greater volatility inherent in such securities." *Id.* at 21.

- **Equities**: "Equity securities in which the [Enhanced Fund] invests may involve substantial risks and may be subject to wide and sudden fluctuations

in market value, with a resulting fluctuation in the amount of profits and losses." *Id.* at 22.

- **Illiquid Securities**: "Securities purchased by the Master Fund may lack a liquid trading market, which may result in the inability of the Master Fund to sell any such security or other investment . . . thereby forcing the Master Fund to incur potentially unlimited losses." *Id.*

In addition, the "Risk Factors" section set forth the same block-type warning included in the High Grade Fund's PPM:

> INTERESTS ARE SPECULATIVE AND INVOLVE A HIGH DEGREE OF RISK. THEY ARE SUITABLE ONLY FOR PERSONS WHO CAN AFFORD TO LOSE THEIR ENTIRE INVESTMENT. THE FOREGOING LIST OF RISK FACTORS DOES NOT PURPORT TO BE A COMPLETE EXPLANATION OF THE RISKS INVOLVED IN THIS OFFERING.

Id. at 29 (capitalization in original).

Epstein's conclusory allegation that the "relevant documents describing the Enhanced Fund concealed" certain problems and risks, therefore, is plainly false. Am. St. Claim ¶ 32. Rather, as was the case when he invested in the High Grade Fund, prior to investing in the Enhanced Fund, Epstein fully understood the increased leverage and the intensely risky nature of his investment. He acknowledged as much on July 26, 2006, when he signed the Subscription Agreement for a Limited Partnership Interest in the Enhanced Fund (Exhibit D), in which he averred, among other things:

- That he had "received and read a copy of the [PPM]" and that he "underst[ood] the investment objectives and policies of, and the investment strategies which may be pursued by, the [Enhanced Fund]";
- That an "investment in the [Enhanced Fund] is consistent with the investment purposes and objectives, and cash flow requirements of the Investor";
- "The Investor has carefully reviewed and understands the various risks of an investment in the [Enhanced Fund], including those summarized under 'Certain Risk Factors' and described in greater detail elsewhere in the [PPM]";

- "The undersigned understands that an investment in the [Enhanced Fund] is speculative and the undersigned can afford to bear the risks of an investment in the [Enhanced Fund], including the risk of losing the undersigned's entire investment"; and

- That he had "evaluated the risks of investing in the [Enhanced Fund] and has determined that the [Enhanced Fund] is a suitable investment" for him.

Ex. D at 7. In addition, Epstein averred that his investment decision was based on the disclosures laid out in the PPM:

> The Investor has received and read a copy of the [PPM] . . . . The Investor acknowledges that in making a decision to subscribe for an Interest the Investor has ***relied solely upon*** the [PPM], the [Enhanced Fund's] Documents, the most recent annual report and accounts of the [Enhanced Fund] (if any) and (where applicable) the most recent unaudited monthly report, and independent investigations made by the Investor.
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> The Investor has carefully reviewed and understands the various risks of an investment in the [Enhanced Fund], including those summarized under "Certain Risk Factors" and described in greater detail elsewhere in the [PPM]; the undersigned understands that an investment in the [Enhanced Fund] is speculative and the undersigned can afford to bear the risks of an investment in the [Enhanced Fund], including the risk of losing the undersigned's entire investment. The undersigned understands that withdrawal rights are limited and may be suspended as set forth in the Limited Partnership Agreement and described in the [PPM].

Id. at 7 (emphasis added).[7]

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[7] In an attempt to distance himself from the documents he signed at the time, Epstein now claims that Spector told him during a brief phone call in 2006 that Spector was "so sure of the safety of the Enhanced Fund that he was investing his own money." Am. St. Claim ¶ 37. Although Spector's personal investment decisions are wholly irrelevant to this action, it is worth noting that Spector never invested his own money in the Enhanced Fund, nor did he tell Epstein that he did so. Indeed, Spector never invested personally in *any* Bear Stearns hedge fund and, given this blanket policy, never represented otherwise. Epstein's assertion to the contrary is baseless. And with respect to Epstein's reference to "safety," the Enhanced Fund was specifically developed to employ *greater* leverage and *additional risk*, which Spector knew and disclosed — both to Epstein and others.

Thus, when Epstein transferred over $20 million to the Enhanced Fund — which, at the time, represented 100% of his interest in the High Grade Fund — he was well aware, and had certified as much in writing, of the significant risks associated with any investment in the Enhanced Fund. Any claim by Epstein that he believed the investment was "secure" or that the Enhanced Fund was "safe" is utter fiction. Furthermore, given Epstein's stated investment strategy — high risk and high return — it defies both common sense and historical fact for him to now assert that he invested in the Funds because he believed they were low risk.[8]

D. The Credit Markets Collapse.

In February 2007, the ABX indices dropped dramatically, triggering an unexpected sequence of events in the credit market, which ultimately caused staggering losses to financial institutions worldwide. At the time, however, Spector's contacts at BSAM told him that, although the Funds might be down, they were down less than the market. Spector therefore

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[8] In his Amended Statement of Claim, Epstein also includes allegations relating to COUQ's 2004 investment in the Bear Stearns Asset Backed Securities Overseas, Ltd Fund (the "ABS Overseas Fund") and FTC's 2006 investment in the Bear Stearns Asset Backed Securities Partners, L.P. Fund (the "ABS Securities Fund") (collectively, the "ABS Fund"). Am. St. Claim ¶¶ 13-14. Like his allegations regarding investments in the High Grade Fund and the Enhanced Fund, Epstein's suggestion that he was somehow misled into investing in the ABS Fund lacks factual basis. The PPM for the ABS Fund set forth its investment objectives and risk factors in detail. Ex. E at 16-27; 28-43. Epstein executed Subscription Agreements at the time of each investment, in which he affirmed that he understood the ABS Fund's strategies and risks, that he was relying on the PPM, and that he was a sophisticated investor capable of evaluating the investment. Ex. F at 2; Ex. G at 2.

Finally, Epstein's allegations regarding the ABS Fund are founded entirely upon the assertion that this fund was related to mortgage-backed securities and, therefore, must somehow suffer from the same types of problems that Epstein claims to have plagued other Bear Stearns hedge funds. Am. St. Claim ¶ 40. This connection is tenuous at best, and clearly does not give rise to a legally sufficient claim. That Epstein "would have caused COUQ to redeem its position in the ABS Fund" had he known more about the Enhanced Fund makes no sense. *Id.* Indeed, Epstein has failed to allege any link between the two funds, other than that the ABS Fund invested in similar types of securities and, unsurprisingly, employed similar valuation methods. *Id.* ¶ 41.

spent the majority of his time addressing Bear Stearns' broker-dealer exposure to the ABX, which was substantial.

Contrary to Epstein's overstated allegations that Bear Stearns somehow knew — in "early 2007," long before any other banks, economists, or financial experts appreciated or understood the magnitude of the subprime crisis — that the Funds were on the brink of a serious liquidity crisis, Spector at no time "engaged in outright and gross deception" or in any way "conceal[ed]" any facts from investors.[9] Am. St. Claim ¶ 42. Rather, Spector and other members of senior management continued to receive reports that, relative to the market, the Funds were not significantly down in the winter of 2007. In March and April, the Funds' returns continued to be down, in part because one of the principal hedges employed by the Funds began to rally in March and thus no longer provided protection against market volatility. Then, in May and June, investors made significant redemption requests and repo counterparties made margin calls, demanding the return of collateral. The consequences of these events followed precisely the trajectory of risks identified by the PPMs; because the securities held by the Funds were highly illiquid and lacked a viable trading market, the Funds were unable to dispose of them, and because of the Funds' increased leverage, losses were significantly magnified.[10]

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[9] In a transparent attempt to cast an aura of criminal suspicion over Bear Stearns as a whole, Epstein repeatedly refers to Ralph Cioffi and Matthew Tannin, the Funds' managers, as "indicted fraudsters." As Epstein is now no doubt aware, Cioffi and Tannin were acquitted of all charges on November 10, 2009.

[10] Epstein also alleges — correctly — that Spector approved an investment of $25 million of the firm's money in the Enhanced Fund in April 2007. Am. St. Claim ¶ 45 n.1. Epstein's characterizations of this investment, however — that Spector did not receive the proper internal authorizations and that he "hid" the investment from the Bear Stearns Board of Directors — are entirely inaccurate. In his capacity as President and co-Chief Operating Officer of Bear Stearns, Spector had the authority to approve — and did routinely approve — investments of this size. At the time he approved the firm's investment, Spector had reason to believe, based upon assurances from BSAM management, that it was a good investment with a likelihood of positive returns.

Sometime in the late spring, Epstein contacted Spector and expressed concern that the Enhanced Fund was recording losses. Epstein's assertion that Spector, during this call, stated that he "intended to purchase additional interests in the fund" is untrue. Am. St. Claim ¶ 45. Spector made no such comments. Nor did he state that the fund "was his baby" and that "all was fine." *Id.* ¶ 9. Nor did he state that Epstein "did not have anything to worry about." *Id.* ¶ 43. Nor did he "convince[] Epstein not to redeem FTC's interest." *Id.* ¶ 44.[11] Nor did he state that "the Enhanced Fund owned assets whose valuations had now been conservatively re-confirmed." *Id.* ¶ 45.

What Spector did tell Epstein was exactly what he was authorized to tell any investor during that time period. Although Spector does not recall the exact words he used on the phone with Epstein that day, Spector had similar conversations with multiple investors during this time period, each of which followed approved talking points. In general, Spector recalls conveying only the facts — specifically, that the market was doing poorly, that the Funds had recorded losses, that the team at BSAM was monitoring the situation closely and working hard to enhance liquidity, and that the right people were focused and doing everything they could to manage the portfolio. By the late spring, however, it was too late; redemptions were eventually suspended and the Funds closed.[12]

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[11] It is worth noting that Epstein's assertion that he would have redeemed his investment in March 2007, the moment a loss was sustained, is inconsistent with his profile as a sophisticated and aggressive investor.

[12] The suspension of redemptions was expressly contemplated and provided for by the PPM. *See* Ex. C at 45 ("If, for any Withdrawal Date, the aggregate amount of withdrawal requests . . . exceeds in value 25% of the Net Asset value of the Master Fund as of such Withdrawal Date, [BSAM] ***may elect to limit such withdrawals and redemptions***.") (emphasis added).

E. Disgruntled, Epstein Looks to Warren Spector as a Scapegoat.

In the aftermath of the Funds' collapse, Epstein remained cordial and professional with Spector and did not attempt to blame him personally for his investment losses. For example, following Spector's departure from Bear Stearns in August 2007, Epstein contacted Spector regarding his future plans. Only now — with time on his hands and two years to contemplate his losses — does Epstein claim that these losses are directly attributable to Spector.

Although he would apparently have this Panel believe otherwise, Jeffrey Epstein is no different than any other investor who lost money when the global credit crisis of 2007 caused the Funds to collapse. His attempt to cast himself as uniquely situated based on a handful of conversations with Spector over a decade-long period is patently absurd. Spector was not his investment advisor, did not offer him substantive advice about how to manage his portfolio, and was not responsible for overseeing any of the funds or products in which Epstein invested. As Epstein himself admits, he was close friends with "many senior executives at Bear Stearns." Am. St. Claim ¶ 3.

Epstein's assertions are deliberately untrue. What is true, on the other hand, is that Epstein lost money and, unwilling to accept responsibility for his very risky investment strategy — a strategy that, for many years, earned him substantial profits — he is now in search of someone to blame and finds himself with few options. But Epstein's unfounded personal attacks do not translate into legal liability for Warren Spector.

EPSTEIN'S CLAIMS FAIL AS A MATTER OF LAW

In one conclusory sentence in his Amended Statement of Claim, Epstein asserts causes of action for constructive fraud, fraudulent inducement, negligent misrepresentation, breach of fiduciary duty, and breach of contract. As a threshold matter, it is unclear what contract Epstein is asserting has been breached, and he has failed to identify any contract to

which he and Spector were parties. It is black-letter law that to assert a claim for breach of contract, plaintiff must allege the existence of a valid enforceable agreement entered into by the parties. 22A N.Y. JUR. CONTRACTS § 443. Accordingly, Epstein has failed to state a claim for breach of contract against Spector. As will be set forth more fully in Spector's Motion to Dismiss, each of the remaining claims is deficient as a matter of law as well.

A. Epstein's Claims for Breach of Fiduciary Duty, Constructive Fraud, and Negligent Misrepresentation Are Barred by New York's Blue Sky Law.

Three of Epstein's claims — those for breach of fiduciary duty, constructive fraud, and negligent misrepresentation — are barred in their entirety by the Martin Act, N.Y. Gen Bus. Law §§ 352(a)-(c) (McKinney 2007), which "prohibits various fraudulent and deceitful practices in the distribution, exchange, sale and purchase of securities." *Castellano* v. *Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001). The Act provides the New York Attorney General with exclusive enforcement powers thereunder, *see id.*, and, as a result, "courts have routinely dismissed private state law securities claims sounding in fraud or deception that do not require pleading or proof of intent, reasoning that to allowing them to proceed would be, in effect, allowing private causes of action under the Martin Act." *Kassover* v. *UBS AG*, 619 F. Supp. 2d 28, 36 ([redacted]. 2008); *see also In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d 405, 421 ([redacted]. 2007) (noting that "[t]he vast majority of state and federal courts" have found such claims preempted by the Martin Act). Applying this settled principle, Epstein's claims that do not require an element of scienter are preempted by the Martin Act. *Kassover*, 619 F. Supp. 2d at 37 (dismissing negligent misrepresentation and breach of fiduciary duty claims as preempted by the Martin Act) (collecting cases).

B. Epstein Has Failed to Establish Facts Supporting any of His Claims.

As set forth above, Epstein's claims for breach of fiduciary duty, constructive fraud, and negligent misrepresentation are preempted by the Martin Act. Even if they were not barred by state statute, however, they would nonetheless fail for a host of other reasons.

1. Epstein cannot establish breach of fiduciary duty.

To establish a claim for breach of fiduciary duty, a plaintiff must show the existence of a fiduciary relationship and a breach of the duty flowing from that relationship. *See Cramer* v. *Devon Group, Inc.*, 774 F. Supp. 176, 184 ([redacted] 1991). As a preliminary matter, Epstein has failed to set forth the basis for any fiduciary relationship between himself and Spector. *See WIT Holding Corp.* v. *Klein*, 724 [redacted].2d 66, 68 (2d Dep't 2001) (dismissing negligent misrepresentation and breach of fiduciary duty claims for failure to allege a special or fiduciary relationship, despite plaintiff's assertions that he and the defendants — who were alleged to have misled him into investing — "had socialized together on several occasions," were "business acquaintances," and "had worked together"). Furthermore, in the absence of any evidentiary basis for Epstein's assertions regarding his alleged conversations with Spector, he cannot establish that Spector breached any duty allegedly owed to him. Accordingly, Epstein's claim for breach of fiduciary duty fails as a matter of law.

2. Epstein cannot establish constructive fraud.

To state a claim for fraud under New York law, a complaint must allege: (1) a misrepresentation or omission of material fact; (2) which the defendant knew to be false; (3) which was made with the intention of inducing reliance; (4) upon which the plaintiff reasonably relied; and (5) which caused injury to the plaintiff. *Burrell* v. *State Farm & Cas. Co.*,

226 F. Supp. 2d 427, 438 ([redacted]. 2002) (citing *Wynn* v. *AC Rochester*, 273 F.3d 153, 156 (2d Cir. 2001)).[13] The elements of constructive fraud are the same as those of fraud, except that the element of scienter is replaced by a fiduciary or confidential relationship between the parties. *Burrell*, 226 F. Supp. 2d at 438 (citing *Klembczyk* v. *Di Nardo*, 705 [redacted].2d 743, 744 (4th Dep't 1999)). Epstein has failed to establish these required elements.

First, Spector did not make the alleged material misrepresentations attributed to him by Epstein. At no time did Spector tell Epstein that the Funds were safe, that Spector was personally monitoring either fund's safeguards and risk protections, or that Spector himself was invested in the Enhanced Fund.

Second, even if Spector *had* made such statements, Epstein cannot plausibly assert that reliance on those statements was reasonable or justifiable in light of the language in the PPMs and the Subscription Agreements. As set forth above, *see supra* at 7-9, 13-15, the PPMs repeatedly disclosed the leverage and risk associated with an investment in the Funds. By signing the Subscription Agreements, Epstein represented that he had read the PPMs, was relying on them, and was an experienced investor competent to make sophisticated investment decisions. Ex. B at 11-12; Ex. D at 7*; see also Olkey* v. *Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 9 (2d Cir. 1996) (dismissing fraud claims where "plaintiffs' claims are contradicted by the disclosure of risk made on the face of each prospectus," and alleged oral misrepresentations "are immaterial since they are contradicted by plain and prominently displayed language in the prospectuses."). Thus, even assuming *arguendo* that certain statements allegedly made by Spector *did* contradict the information contained in PPMs — which they did not — as a

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[13] The elements of common law fraud are essentially the same as those required to demonstrate violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (2007), and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (2008). *See 380544 Can., Inc.* v. *Aspen Tech., Inc.*, 544 F. Supp. 2d 199, 216 ([redacted]. 2008).

sophisticated investor, Epstein cannot claim reasonable reliance on them. *Wurtsbaugh* v. *Banc of Am. Sec. LLC*, 2006 U.S. Dist. LEXIS 40473, at *19 ([redacted]. June 20, 2006) ("In assessing whether reliance is reasonable, the entire context of the transaction is considered 'including factors such as its complexity and magnitude, the sophistication of the parties, and the contents of any agreements between them.' When plaintiffs are sophisticated parties and the statement or omission relates to a business transaction that has been formalized in a contract, New York courts are generally reluctant to find reliance on oral communications to be reasonable.") (quoting *Emergent Capital Inv. Mgmt. LLC* v. *Stonepath Group, Inc.*, 343 F.3d 189, 195 (2d Cir. 2003)).

Third, as discussed above, Epstein's allegations regarding the fiduciary nature of his relationship with Spector are false. Contrary to Epstein's assertions, Epstein and Spector were business acquaintances, having crossed paths only occasionally since the 1990s. *See supra* at 4-6. Moreover, even if the handful of conversations Spector had with Epstein were somehow considered a professional friendship, such a relationship does not alone justify Epstein's purported reliance on Spector's alleged statements.[14] *Cf. Emergent Capital*, 343 F.3d at 196 (finding sophisticated investor's reliance on alleged extra-contractual representations unreasonable despite parties' personal friendship).

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[14] This proposition remains true despite Epstein's unfounded assertion — made solely by his inclusion of a breach of fiduciary claim in his Amended Statement of Claim — that his relationship with Spector was fiduciary in nature. *See Carlin Equities Corp.* v. *Mayer Offman*, 2008 U.S. Dist. LEXIS 74375, at *22 ([redacted]. Sept. 24, 2008) (noting that "the Second Circuit did not hold in *Emergent Capital* that a plaintiff's reliance on the representations of a fiduciary would be reasonable even if such reliance would have been unreasonable as a matter of law if based on the statements of a non-fiduciary. . . . [T]he question is whether a party's reliance was reasonable in light of the entire context of the transaction. Notably, none of the cases following *Emergent Capital* has even mentioned the existence or absence of a fiduciary relationship between the parties as a relevant consideration in this inquiry.").

Finally, Epstein has failed to establish that his decision to invest in the funds was a result of his alleged conversations with Spector. Not only was Epstein an experienced investor with access to myriad sources of investment information and advice, but as he readily admits, he also had an ongoing relationship with Bear Stearns and a close personal relationship with Cayne. *See* Am. St. Claim ¶ 19 ("For more than 26 years, Epstein invested millions of dollars in various Bear Stearns' sponsored investments, relying principally on the assurances, advice and representations of Spector *and other executives at the highest levels of Bear Stearns' management*."). In light of his extensive ties to Bear Stearns and long history of investing, it is illogical for Epstein to assert that he would not have invested in the Funds had it not been for one specific brief conversation with Spector.

Nor can Epstein establish a causal relationship between Spector's alleged misrepresentations and Epstein's ultimate financial losses following the closure of the Enhanced Fund. The Funds collapsed as a result of the unprecedented credit crisis, which also devastated a number of other high-profile banking institutions. Epstein, like all other investors, suffered losses in proportion to his investments. *See, e.g.*, *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 771-72 (2d Cir. 1994) (finding no causation where, *inter alia*, the plaintiff's investment was followed by a real estate market collapse); *Hampshire Equity Partners II, L.P.* v. *Teradyne, Inc.*, 2005 U.S. Dist. LEXIS 5261, at *16 ([redacted]. Mar. 30, 2005) ("[W]hen a plaintiff's loss coincides with a market-wide phenomenon causing comparable losses to other investors, the probability that the loss was caused by an alleged fraud decreases.") (citing *First Nationwide Bank*, 27 F.3d at 772); *see also Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) (finding no loss causation where plaintiffs lost investment in an oil and gas limited partnership during a year when the vast majority of such limited partnerships became worthless,

noting that "[n]o social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation.").

3. Epstein cannot establish negligent misrepresentation.

To establish a claim for negligent misrepresentation under New York law, Epstein must prove that "(1) the defendant had a duty, as a result of a special relationship, to give correct information; (2) the defendant made a false representation that he or she should have known was incorrect; (3) the information supplied in the representation was known by the defendant to be desired by the plaintiff for a serious purpose; (4) the plaintiff intended to rely and act upon it; and (5) the plaintiff reasonably relied on it to his or her detriment." *Barron Partners, LP* v. *Lab123, Inc.*, 593 F. Supp. 2d 667, 674 ([redacted]. 2009) (quoting *Hydro Investors, Inc.* v. *Trafalgar Power, Inc.*, 227 F.3d 8, 20 (2d Cir. 2000)). As set forth above, Epstein and Spector had no special or fiduciary relationship, Spector made no false representations, and any reliance on the type of misrepresentation Epstein alleges to have been made is not only implausible, but also unreasonable as a matter of law.

C. Epstein Has Failed to Establish Scienter.

Epstein's sole claim that requires a finding of scienter — fraudulent inducement — also fails as a matter of law. "Although scienter need not be pled with great specificity, . . . 'there must be some factual basis for conclusory allegations of [fraudulent] intent.'" *Miller* v. *Holtzbrinck Publishers, LLC*, 2009 U.S. Dist. LEXIS 18973, at *9 ([redacted]. Mar. 3, 2009) (quoting *Ouaknine* v. *MacFarlane*, 897 F.2d 75, 80 (2d Cir. 1990)). Epstein does not have "'license to base claims of fraud on speculation and conclusory allegations.'" *Shields* v. *Citytrust Bancorp. Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (quoting *O'Brien* v. *Nat'l Prop.*

Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991)). Thus, he "must allege facts that give rise to a strong inference of fraudulent intent," including "(1) facts to show that the defendant had both motive and opportunity to commit fraud, or (2) facts constituting strong circumstantial evidence of conscious misbehavior or recklessness." *Miller*, 2009 U.S. Dist. LEXIS 18973, at *9 (citing *Shields*, 25 F.3d at 1128).

Epstein has done neither. Indeed, the Amended Statement of Claim is conspicuously devoid of any facts supporting any assertion that Spector maliciously took advantage of Epstein's alleged trust in him. Furthermore, Epstein's speculation as to motive is illogical and unconvincing. First, Epstein offers no plausible explanation why Spector would be inclined to single out Epstein and mislead him regarding the nature of the Funds or Spector's involvement in them. In fact, it defies common sense to suggest that the co-COO of Bear Stearns would go out of his way to mislead and harm a VIP client such as Epstein. *See, e.g.*, *Kalnit* v. *Eichler*, 264 F.3d 131, 140-41 (2d Cir. 2001) ("Where 'plaintiff's view of the facts defies economic reason, . . . [it] does not yield a reasonable inference of fraudulent intent.'") (quoting *Shields*, 25 F.3d at 1130).

Second, as set forth in detail above, the only allegations in Epstein's Amended Statement of Claim that could possibly be interpreted to suggest motive are unsupported by the facts and utterly contrived. *See supra* at 10-12. A far cry from the detailed and specific allegations of a concrete personal benefit that are required to support a finding of scienter, Epstein's inaccurate conjectures about alleged problems with the High Grade Fund's portfolio and the attenuated relationship between any such problems and Spector's compensation are insufficient to meet the high standard required to establish motive. *See, e.g.*, *Rombach* v. *Chang*, 355 F.3d 164, 177 (2d Cir. 2004) (affirming dismissal of plaintiff's claims for failure to plead

scienter where plaintiff failed to "allege that defendants engaged in these transactions to secure personal gain," where there was "no indication that [defendant] stood to profit substantially from the arrangement," and where not only were there no allegations "that defendants sold stock or profited in any way during the relevant period," but, to the contrary, defendants "shared the pain when the company failed."). Accordingly, Epstein's fraudulent inducement claim fails as a matter of law.

D. All Claims Asserted are Barred by the Exculpatory Clause in the Funds' Limited Partnership Agreements.

Both the High Grade and Enhanced Funds' limited partnership agreements contain clauses stating that "any member, partner, shareholder, manager, director, officer, employee, or agent" of BSAM, "shall not be liable for monetary or other damages . . . for losses sustained or liabilities incurred . . . as a result of: (i) errors in judgment . . . or any act or omission" if acting "without fraud, bad faith, gross negligence, or willful misconduct." Article I, X § 10.1(a). Given his failure to establish any fraudulent intent or motive on Spector's part, Epstein's claims are barred by the exculpatory clause.

E. Epstein is not Entitled to Recover Punitive Damages.

In addition to his claim for $45 million, Epstein demands punitive damages. "To sustain a claim for punitive damages in tort, one of the following must be shown: intentional or deliberate wrongdoing, aggravating or outrageous circumstances, a fraudulent or evil motive, or a conscious act that willfully and wantonly disregards the rights of another." *Don Buchwald & Assocs.* v. *Rich*, 723 [redacted].2d 8, 9 (1st Dep't 2001) (citation omitted). Epstein cannot demonstrate, under any set of facts, that the claims here are sufficiently egregious to warrant such extraordinary relief.

DENIAL OF CLAIMS

Spector denies each and every allegation of wrongdoing and liability set forth or implied in the Amended Statement of Claim. Spector further denies that Claimants have been injured as a result of any allegedly wrongful conduct by him. Spector requests that all claims be dismissed with prejudice, with all costs and fees incurred by Respondent assessed against Claimants. Spector reserves the right to amend his answer as additional information becomes available during the discovery process.

AFFIRMATIVE DEFENSES

1. The Amended Statement of Claim fails to state a claim upon which relief may be granted.

2. Claimants were not damaged by any action or inaction of Respondents.

3. Claimants' claims are barred by the Exculpation Clause in the Subscription Agreements.

4. Any losses suffered by Claimants resulted from market conditions or fluctuations normally associated with investments in the securities markets that were beyond the control and responsibility of Respondents.

5. Claimants knowingly, voluntarily, and willingly assumed the risks of any of the alleged harms about which they now complain.

6. Claimants' claims are barred in whole or in part because of the contributory negligence or comparative fault of the Claimants or of other persons or entities not named as Respondents.

7. The conduct of persons or entities other than Respondents was a superseding or intervening cause of any damage, loss, or injury allegedly incurred by Claimants.

8. Claimants are estopped from pursuing any claims against Respondents because they signed Subscription Agreements acknowledging that they were sophisticated investors who carefully reviewed the Funds' PPMs, including the risk factors set forth therein, and that they were capable of understanding and in fact understood and agreed to take on these risks.

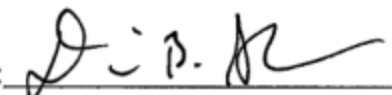
9. Any losses Claimants suffered were a result of Claimants' own conduct.

CONCLUSION

For the foregoing reasons, Epstein's claims are wholly without merit. Respondent Spector respectfully requests that the Amended Statement of Claim be dismissed in its entirety, and that Claimants be directed to pay the costs, fees and expenses incurred in connection with this proceeding.

Dated: New York, New York
December 4, 2009

WACHTELL, LIPTON, ROSEN & KATZ

By: 

David B. Anders
Meredith L. Turner

51 West 52nd Street
New York, New York 10019
[redacted]

Attorneys for Respondent Warren Spector