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**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re:

LEHMAN BROTHERS INC.,

Debtor.

Case No.: 08-1420 (JMP) SIPA

**STATEMENT IN FURTHER SUPPORT OF THE
SECOND MOTION FOR ORDER APPROVING
THE TRUSTEE'S ALLOCATION OF PROPERTY**

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James W. Giddens (the “Trustee”), as trustee for the liquidation of the business of Lehman Brothers Inc. (the “Debtor” or “LBI”) under the Securities Investor Protection Act of 1970, as amended (“SIPA”), 15 U.S.C. § 78aaa et seq.,¹ by and through his undersigned counsel, hereby submits this Statement in further support of the Second Motion for Order Approving the Trustee’s Allocation of Property, filed December 1, 2011 (Docket No. 4760) (the “Second Allocation Motion”).

INTRODUCTION

1. The task of allocating assets to the fund of customer property under SIPA remains a fundamental administrative step that must be completed for purposes of planning and as a prerequisite to interim and final distributions. The greatest possible certainty at the earliest possible time will promote transparency and will facilitate analysis of likely outcomes for the benefit of the Trustee and the many customers and creditors of LBI. As in the case of Plan confirmation in proceedings relating to the chapter 11 debtors — with potential disputes greatly exceeding in legal and factual scope any potentially disputed allocation issues here — it is believed that a defined and feasible pre-hearing schedule will serve the interests of the LBI Estate, its customers and its other creditors.

2. In the five months that have passed since the filing of the Second Allocation Motion, the body of property to be allocated remains fundamentally the same, although certain events and the passage of time have affected the measurement and description of the assets subject to allocation.

3. During this period, the Trustee’s professionals have engaged in exchanges of information with interested parties (including Lehman Brothers Holdings Inc. (“LBHI”) and

1. References to SIPA refer to the statutory sections in effect as of the commencement of LBI’s liquidation.

its affiliate debtors, the Official Committee of Unsecured Creditors of LBHI, Lehman Brothers International (Europe) (“LBIE”), and various ad hoc groups), with a view to facilitating a due diligence review by interested parties and achieving consensus around the items involved in the Trustee’s proposed allocation. As of the date of this Statement, the Trustee and the principal parties have reached agreement as to most of those items, including the “core” customer property and identified compliance failures (except as to the LBIE shortfall issue discussed below) that together constitute approximately 80% of the proposed fund of customer property.² With respect to the remaining allocation items — related to resources provided through the use of customer debit items and funds returned to the Estate by the Depository Trust & Clearing Corporation and its subsidiaries (collectively, “DTCC”) — agreement has not yet been reached, although exchanges of information with interested parties will continue in the hope of achieving further consensus. In the event that Court intervention is necessary to resolve any remaining differences on these items, the Trustee and interested parties will be able to present their evidence and arguments on the administrative issues raised by the Second Allocation Motion within a matter of months and without the kind of protracted pre-trial process that might be seen in “scorched earth” litigation adjudicating rights as between adverse parties.

4. Section I below describes measurement and description updates to the Estate corresponding to the five-month interval since the filing of the Second Allocation Motion. Section II describes updates to the Trustee’s proposed allocation scheme. Section III sets forth the Trustee’s proposal regarding disposition of the Second Allocation Motion.

2. The Trustee anticipates that the parties will be in a position to present the Court with a joint proposed order authorizing the Trustee to allocate the agreed-upon items in the near future.

I. UPDATED COMPOSITION OF THE ESTATE — ASSETS TO BE ALLOCATED

5. As reported in the Trustee's Seventh Interim Report for the Period October 22, 2011 through April 20, 2012, filed April 20, 2012 (Docket No. 5035) (the "Seventh Interim Report"), based on valuations updated to March 30, 2012, the Trustee has approximately \$25.7 billion³ in assets under his control. This includes approximately \$3.2 billion in assets held in reserve pending the outcome of appeals related to the Trustee's litigation with Barclays Capital Inc. ("Barclays").⁴ Changes to the elements making up this total since the filing of the Second Allocation Motion are described below.

A. Securities Held by the Trustee

6. The Trustee holds securities (other than securities representing post-petition investment of Estate cash) valued at \$13,748,163,442 as of March 30, 2012.^{5,6} (See Supp. Decl. of Moshe Sinensky, executed Apr. 27, 2012 ("Sinensky Supp. Decl."), submitted herewith, ¶ 4.) Although the underlying securities are substantially the same, this represents a dollar-value increase of approximately \$1.1 billion compared to the amount reported in the Second Allocation Motion. (Compare id. with Decl. of Moshe Sinensky, executed Dec. 1, 2011 (Docket No. 4764) ("Sinensky Dec. 1 Decl.") ¶ 3.)

3. Unless otherwise noted, asset values referenced herein are as of March 30, 2012, the valuation date used in the Seventh Interim Report. Asset values referenced in the Second Allocation Motion were as of September 30, 2011, the valuation date used in the Trustee's Sixth Interim Report for the Period April 23, 2011 through October 21, 2011, filed October 21, 2011 (Docket No. 4657).

4. See Seventh Interim Report Ex. 1 note (e).

5. The value of securities set forth in the Seventh Interim Report includes approximately \$11.6 billion of Estate cash that has been invested in certificates of deposit and similar securities ("Trustee Investments"). (See Seventh Interim Report Ex. 1.) The value represented by these securities is treated as cash for purposes of the Second Allocation Motion and addressed in section I.B, below.

6. As described in the Seventh Interim Report ¶ 6, available market data was used to calculate the market value of securities. Where market data was not available within 30 days of the report date, the security was valued at zero. Since LBI is in liquidation and does not carry on an active trading operation, the Trustee does not maintain a trading desk that can obtain reliable pricing information on securities that are not regularly traded.

B. Cash and Cash Equivalents

7. The Trustee has approximately \$11,891,584,985⁷ in cash and cash equivalents in his control. (See Supp. Decl. of Gabriela Huaman, executed Apr. 28 2012 (“Huaman Supp. Decl.”), submitted herewith, ¶ 3.) This represents an increase of approximately \$880 million from the amount reported in the Second Allocation Motion. (Compare id. with Decl. of Gabriela Huaman, executed Dec. 1, 2011 (Docket No. 4765) (“Huaman Dec. 1 Decl.”) ¶ 4.)

II. UPDATED PROPOSED ALLOCATION SCHEME

8. As described in the Second Allocation Motion, the Trustee proposes to allocate assets under his control to the fund of customer property based on principles drawn from SIPA and established by the Court’s Order with respect to the First Allocation Motion. The principal allocation categories are as follows: (a) “core” customer property; (b) property reallocated to the fund of customer property based on compliance failures; (c) resources provided through the “use or realization” of customer debits; and (d) a proportionate share of property that has a relationship to both customer and non-customer transactions. To the extent there are updates to the items within these categories, they are described below.

A. “Core” Customer Property

9. “Core” customer property consists of assets “received, acquired, or held” for the accounts of customers in accordance with SIPA. See SIPA § 78III(4); Second Allocation Motion ¶¶ 4, 43-45, 73-81. Updates to “core” customer property are described in detail in the

7. This figure reflects only the purchase price of the Trustee Investments and not any unrealized gains or losses. Unrealized gains or losses are, however, reflected in the Estate total of \$25.7 billion reported in the Seventh Interim Report.

Supplemental Declarations of Moshe Sinensky and Gabriela Huaman, both submitted herewith, and are summarized below.

1. Trustee-Controlled Securities

10. Of the \$13,748,163,442 of securities in the Trustee's control, securities valued at \$10,620,786,744 as of March 30, 2012 are held for customers. (See Sinensky Supp. Decl. ¶ 4.) This represents a dollar-value increase of approximately \$1.4 billion compared to the amount reported in the Second Allocation Motion. (Compare id. with Sinensky Dec. 1 Decl. ¶ 9.) This is due both to market movement during the period and certain changes in valuation methodology.

2. Trustee-Controlled Cash

11. Of the \$11,891,584,985 of cash and cash equivalents in the Trustee's control, \$2,902,463,007 relates to customer accounts as of March 30, 2012. (See Huaman Supp. Decl. ¶ 18.) This is an increase of approximately \$435 million from the amount reported in the Second Allocation Motion. (Compare id. with Huaman Dec. 1 Decl. ¶ 26.)

B. Compliance-Based Allocation

12. Sub-paragraph (D) of the SIPA definition of Customer Property takes in "any other property of the debtor which, upon compliance with applicable laws, rules, and regulations, would have been set aside or held for the benefit of customers" SIPA § 78III(4)(D). The Second Allocation Motion identifies numerous failures in LBI's compliance with applicable laws, rules, and regulations governing the segregation of customer property, totaling \$3,194,053,702. (See ¶¶ 82-106.) One of those compliance failures, related to the omnibus accounts LBI maintained for customers of LBIE (the "LBIE Shortfall"), is subject to continuing developments and its expressed value is therefore only an estimate (of \$1 billion). (See id. ¶¶ 95-100.) While the amount can only be estimated given continuing lack of clarity as

to the precise content of the LBIE customer claim, the underlying principle — that a compliance failure occurred to the extent that property should have been locked up for LBIE customers but was not — should not be the subject of sharp disagreement, and can be decided at this time.

13. The balance of the compliance failures identified in the Second Allocation Motion, totaling \$2,194,053,702, have been confirmed through additional diligence by the Trustee’s professionals as well as other interested parties. Consistent with the plain language of SIPA and prior order of the Court, “other” assets of the Estate must be allocated to the fund of customer property to remediate these compliance failures. (See Order Approving Trustee’s Motion for Allocation of Property of the Estate, Mar. 2, 2010 (Docket No. 2743), at 2.) It is anticipated that the Trustee and interested parties will be in a position to present to the Court an agreed order covering these points in the near future.

C. Resources Provided through the Use or Realization of Customer Debit Balances

14. Sub-paragraph (B) of SIPA’s definition of Customer Property takes in “resources provided through the use or realization of customers’ debit balances and other customer-related debit items as defined by the Commission by rule.” SIPA § 78III(4)(B). The Second Allocation Motion identifies resources aggregating to \$2,009,508,104 that have been generated by the Estate from LBI customer debit items. (See ¶¶ 108-114.) In fact, that figure is understated by \$175,269,530; resources of at least \$2,184,777,634 fall into this category and should be allocated to the fund of customer property.

15. The assets in this category derive from debits used in the transfer of Private Investment Management (“PIM”) customer accounts to Barclays Capital Inc. (“Barclays”) and Private Asset Management (“PAM”) customer accounts to Ridge Clearing &

Outsourcing Solutions Inc. (“Ridge”).⁸ The figures stated in the Second Allocation Motion — \$1,459,810,100 of debits for PIM and \$549,698,004 of debits for PAM — represent only the cash debits that were used in the account transfer process and do not include debit items in the form of short securities positions. (See ¶¶ 110-112.) At the time the Second Allocation Motion was filed, and as noted therein (¶ 111, n.48), the long and short securities positions that transferred along with the cash credits and debits in the PIM and PAM customer accounts were still under review. Subsequent analysis conducted by the Trustee’s professionals shows that short positions in a given security were used to offset long positions in that security for the purposes of making a net transfer of the security position to Barclays or Ridge. Further, for certain securities where the netting of long and short positions resulted in a net customer short position, Barclays or Ridge delivered securities (or cash in lieu of securities) to the Trustee to satisfy those net short positions. The values of the debits so used were \$136,144,414 for PIM and \$39,125,116 for PAM. (Sinensky Supp. Decl. ¶¶ 5-6.) Combining the cash and securities debits used in the PIM and PAM account transfers, \$2,184,777,634 should be allocated to the fund of customer property.

D. Property Associated with Both Customer and Proprietary Accounts

16. The Trustee currently controls assets totaling at least \$2,472,654,252 that are derived from or are proceeds of both customer and proprietary activity. (Second Allocation Motion ¶¶ 21, 115; see also Huaman Dec. 1 Decl. ¶ 9.) The Second Allocation Motion describes these funds as related to LBI’s customer and proprietary trading activities. (¶ 115.) Subsequent investigation has revealed that these funds (the “DTCC Funds”) represent the commingled

8. Resources provided through the use or realization of other debits are either covered in separate sections of the Second Allocation Motion or are subject to withholding for contingency reserves. (See Second Allocation Motion ¶¶ 109, 113-114.)

proceeds of customer and proprietary transactions closed out at DTCC after the Filing Date.

Further property having similar characteristics may be identified or recovered in connection with the Barclays litigation.

17. As a member of and participant in the subsidiaries of DTCC, LBI was obligated to maintain deposits in amounts prescribed by the various subsidiaries. (See Decl. of Marlo Karp, executed Apr. 28, 2012 (“Karp Decl.”), submitted herewith, ¶ 3.) During the weeks preceding the commencement of LBI’s liquidation, DTCC required LBI to increase significantly the amounts on deposit, with the aggregate amount increasing from approximately \$735 million on September 5, 2008 to approximately \$1.8 billion on the Filing Date.⁹ (Id.) A portion of this total corresponded to property posted as collateral by LBI’s customers. (Id.)

18. Clearance and settlement activity at DTCC did not cease on the Filing Date, but rather continued through September 24, 2008. (Id. ¶ 4.) Even after September 24, 2008, there was activity to close out a significant volume of failed trades and trades for future settlement. (Id.) Information provided by DTCC shows that, subsequent to the Filing Date and through September 24, 2008, billions of dollars in gross credits and billions of dollars in gross debits were entered in the LBI accounts at the DTCC subsidiaries. (Id.) Information and analysis provided by DTCC also show that, after September 24, 2008, further net credits of at least \$1.4 billion and net debits of at least \$386 million were applied to LBI balances at the DTCC subsidiaries. (Id.)

19. The DTCC subsidiaries typically do not know the identities of the underlying customers, or which trades are customer and which are proprietary. (Id. ¶ 5.) The

9. The sources of these increased deposits remain under investigation by the Trustee.

result is that debits and credits are netted by DTCC against one another, without distinguishing whether they are customer or proprietary. (Id.)

20. In sum, the DTCC Funds that ultimately were returned by DTCC to the LBI Estate are the result of an overall netting process that did not take account of the difference between customer and proprietary rights and obligations with respect to settlement and closeout activity. Accordingly, it is not known what portion of these funds returned by DTCC is properly viewed as customer and what portion is properly viewed as proprietary.

21. The Trustee initially proposed to allocate the DTCC Funds in the ratio of 60% customer and 40% proprietary, in accordance with the “business mix” calculation performed pursuant to Securities and Exchange Commission Rule 11a1-1(T). (See Second Allocation Motion ¶¶ 54-59, 115-117.) In subsequent discussions, certain parties questioned whether alternative means existed to determine the respective customer and proprietary proportions. The Trustee’s professionals then conducted an analysis to identify the percentage of customer held DTCC-eligible securities that LBI allocated to good control locations compared to firm and non-customer held DTCC-eligible securities at good control locations as of the Filing Date. Based on the Filing Date market value of the securities so identified, 77.2% of such value of DTCC-eligible securities was allocated to customers. (Sinensky Supp. Decl. ¶ 8.) Accordingly, 77.2% of the DTCC Funds — \$1,908,889,083 — should be allocated to the fund of customer property.

III. DISPOSITION OF THE SECOND ALLOCATION MOTION

22. The Trustee and interested parties are currently in disagreement regarding the process to get to final determination of the Second Allocation Motion regarding the three categories of issues that remain unresolved. As noted above, the Trustee’s position is based on the need to complete the administrative aspects of the LBI liquidation to the greatest extent

possible in the near term. This will enable the Trustee to make distributions to customers whose accounts could not be transferred to other brokers during the early days of the liquidation, and plan for the ultimate conclusion of the liquidation when matters such as the claims of LBIE, LBHI and others will be resolved.

23. Fixing the size of the customer fund is fundamental to any distribution scheme — whether interim or final — under SIPA, and the issues and asset values raised by the Second Allocation Motion must be resolved in the near term. Any contrary position, which would postpone essential action on allocation for months or years, is believed to be based on the assumption that a huge fact discovery process followed by an expert discovery process must be completed in order to make an adequate record to decide relevant issues. This assumption is incorrect.

24. It is simply not the case that discovery must encompass years of transactions affecting the DTCC Funds or the debit items involved in the PIM and PAM transfers, the categories (other than the LBIE Shortfall) that are not yet agreed. These are discrete issues. The relevant events occurred over a period of days or weeks — not years — and the parties will be well able to prepare presentations of evidence and argument within a three- or four-month time frame. It is also anticipated that disputed issues will tend to be legal rather than factual in nature — nothing involved here is likely to raise a large number of disputed factual issues in the manner of the Barclays trial or the substantive consolidation issues potentially in issue in connection with the chapter 11 debtors' Plan confirmation. Thus, adding time to the schedule will not aid in developing facts or creating a record sufficient to decide the relevant issues. Three-plus years into this case, finality must be reached as to key administrative issues such as defining the fund of customer property to pave the way for return of property to the

approximately one thousand customers with allowed claims.

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April 30, 2012

Respectfully submitted,

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