IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

In re:	)	Chapter 11
	)	
SENTINEL MANAGEMENT GROUP, INC.,	)	**CASE NO. 07 B 14987**
	)	
Debtor.	)	Hon. John H. Squires
	)	
	)	
FREDERICK J. GREDE, as Chapter 11 Trustee for Sentinel Management Group, Inc.,	)	
	)	
Plaintiff,	)	
v.	)	
	)	**ADV. NO. ______________________**
FARR FINANCIAL INC.,	)	
	)	
Defendant.	)	
	)	
	)	

COMPLAINT

Plaintiff Frederick J. Grede, not individually but as Chapter 11 Trustee for Sentinel Management Group, Inc. ("the Trustee"), hereby states for his Complaint as follows:

NATURE OF THE ACTION

1. This is an adversary proceeding by the Trustee against Farr Financial, Inc. ("Farr" or "Defendant") to avoid $10,070,845 in post-petition transfers improperly made to or for the benefit of Farr, to avoid $3,613,658 in preferential pre-petition transfers to or for the benefit of Farr, and to declare that funds and securities held in allegedly "segregated" accounts are not property of Farr or its customers, but are property of the Debtor's estate.

2. Farr was a Sentinel customer with an account in Sentinel's "SEG 1" customer pool. At the heart of this action is the claim by Farr and certain other SEG 1 customers that any assets held by Sentinel in any accounts denominated as "segregated" for SEG 1 were and are the

property of customers in the SEG 1 pool, no matter the actual source of the funds or the circumstances under which they were deposited into those accounts. At issue are pre-petition transfers to Farr, funds distributed to it post-petition as part of the Citadel sale, and funds still remaining in the accounts called SEG 1, SEG 2 and SEG 3. Farr's view is that the funds in the account called SEG 1 belong to it and other SEG 1 customers, not the estate, regardless of whether segregation actually existed and without regard to how Sentinel actually obtained these funds.

3. Farr's claim arises from fictitious and fraudulent account statements created by certain insiders at Sentinel that purported to show segregation. In fact, there was no segregation of customer funds by Sentinel and its custodian bank, the Bank of New York ("BONY"). Sentinel and BONY commingled customer assets and treated all cash and securities controlled by Sentinel as being part of a single undifferentiated pool which was used principally for the benefit of the Sentinel insiders and BONY. As a result, the assets in supposedly "segregated" accounts were and are property of the Debtor's bankruptcy estate.

JURISDICTION AND VENUE

4. This Court has jurisdiction pursuant to 28 U.S.C. § 1334(b) because this adversary proceeding is related to and arises under the Chapter 11 case, *In Re Sentinel Management Group, Inc.*, pending in the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division, as Case No. 07 B 14987.

5. Venue is proper in this District pursuant to 28 U.S.C. § 1409(a).

6. This Complaint is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (C), (F) and (O).

THE PARTIES AND RELATED ENTITIES

7. Plaintiff Frederick J. Grede is the chapter 11 trustee for the Debtor, duly appointed under Section 1104 of the Bankruptcy Code by Orders of this Court dated August 23 and 29, 2007.

8. Sentinel is an Illinois corporation which was at relevant times headquartered in Northbrook, Illinois. Sentinel was registered with the Securities and Exchange Commission ("SEC") as an investment adviser and with the Commodity Futures Trading Commission ("CFTC") as a futures commission merchant ("FCM").

9. Defendant Farr is a California corporation with its principal place of business in San Jose, California. Defendant Farr is registered with the CFTC as an FCM. Farr was a member of Sentinel's SEG 1 customer pool.

SENTINEL'S PURPORTED CUSTOMER POOLS

10. Sentinel primarily managed investments of short-term cash for various clients, including other FCMs, hedge funds, financial institutions, pension funds, and individuals.

11. Sentinel solicited clients by offering them the opportunity to participate in a variety of supposedly safe investment programs, each of which purportedly had its own investment policy designed to meet the requirements and risk profiles of different types of clients. Regardless of which investment program a particular client chose, Sentinel purportedly pooled the client's assets with those of similar types of clients in segregated client custodial accounts maintained at the Bank of New York. The accounts were referred to within Sentinel as SEG 1, SEG 2 and SEG 3.

12. SEG 1 was supposed to contain customer funds and property of registered FCMs. The investment of FCM customers' funds is subject to the provisions of the Commodity

Exchange Act ("CEA"), 7 U.S.C. § 1 et seq., and the rules and regulations promulgated thereunder by the CFTC, 17 C.F.R. § 1.1 - 190.10, including the strict investment standards embodied in CFTC Rule 1.25, 17 C.F.R. § 1.25, and generally is supposed to consist of only the highest grade securities and similar highly liquid investments.

13. SEG 2 was supposed to contain the funds and property of FCM customers that are engaged in trading at foreign exchanges, invested in accordance with CFTC Rule 30.7, 17 C.F.R. § 30.7. Rule 30.7 imposes restrictions on the investment of customer funds similar to those in Rule 1.25.

14. SEG 3 was supposed to contain assets of all other types of clients, including FCMs' own (*i.e.*, non-customer) funds, hedge funds, trust accounts, endowments and individuals. About 75% in amount of the SEG 3 investments were supposed to be invested in Rule 1.25 compliant securities.

15. In addition to the supposed SEG 1, SEG 2, and SEG 3 customer pools, Sentinel managed a "House" or "Street" portfolio, which was a portfolio of securities held by Sentinel for the ultimate benefit of certain insiders, including Sentinel's chairman, Philip Bloom, its CEO, Eric Bloom, and its vice-president of trading, Charles Mosley.

16. The creation of these customer SEG pools was the product of two federal regulatory schemes that governed Sentinel's business. Both required that customer assets in SEGS 1, 2 and 3 be segregated from the assets of other SEG pools and Sentinel itself.

17. Because Sentinel was an FCM managing funds required to be segregated for the benefit of commodity customers, Sentinel was subject to the provisions of the CEA and CFTC rules and regulations promulgated thereunder.

18. Section 4d(a)(2) of the CEA provides that money, securities and property of customers must be separately accounted for and not commingled with the funds of the FCM. 7 U.S.C. § 6d(a)(2).

19. Section 4d(b) of the CEA provides that "it shall be unlawful for any person. . . that has received any money, securities and property for deposit in a separate account as provided for in [section 4d(a)(2) of the CEA], to hold, dispose of, or use any such money, securities or property as belonging to the depositing futures commission merchant or any person other than customers of such futures commission merchant." 7 U.S.C. § 6d(b).

20. CFTC Rule 1.20(a) provides that all customer funds shall be segregated as belonging to commodity customers, and that when deposited with any bank, shall be deposited under an account name which clearly identifies them as customer property.

21. Sentinel was also registered as an investment adviser and was subject to the provisions of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.* (the "Investment Advisers Act"), and the rules and regulations of the SEC promulgated thereunder, 17 C.F.R. §§ 275.0-2 – 275.222-2.

22. Section 206 of the Investment Advisers Act makes it illegal to "employ any device, scheme, or artifice to defraud any client or prospective client" and to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6.

23. The regulations promulgated by the SEC under section 206 provide that it is a "fraudulent, deceptive, or manipulative act, practice, or course of business" to have custody of client funds or securities except as provided in SEC Rule 206(4)-2. SEC Rule 206(4)-2, 17 C.F.R. § 275.206(4)-2, requires that client funds and securities be maintained at a "qualified

custodian," which includes a depository bank, "[i]n a separate account for each client under that client's name" or "[i]n accounts that contain only [the investment adviser's] clients' funds and securities, under [the investment adviser's] name as agent or trustee for the clients."

24. It also is a violation of Section 206 of the Investment Advisers Act to use one client's assets to cover or secure securities purchases for another client when the former client does not have sufficient cash in its account to cover securities purchases on the settlement date.

25. Thus, under both regulatory regimes, Sentinel was supposed to segregate the assets of its customers in SEGs 1, 2, and 3 from the other SEG accounts and from Sentinel's House account.

26. In addition to the requirements of federal law, Sentinel's relationship with its customers was also supposed to be governed by an "Investment Advisory Agreement" or, with respect to certain accounts during and after 2004, an "Investment Management Agreement" (collectively "the Investment Agreements") and other representations made by Sentinel to its customers. The Investment Agreements provided discretionary authority to Sentinel to select, buy and sell securities without requesting authority from clients before executing the trades. The Investment Agreements often included an Addendum specifying the investment policy that Sentinel was supposed to use to invest the client's funds.

27. The Investment Agreements entered into by all customers of all SEGs also provided that the customer's assets would be deposited in a custodial account for the benefit of the customer and that Sentinel would not have any interest in the funds or securities in the account.

28. The Investment Management Agreements and Sentinel's regulatory filings with the SEC also specified that the client's assets in a particular program would be invested along

with the assets of other Sentinel clients in the same program and that the client would own an indirect interest in the segregated portfolio of the relevant program. Sentinel's detailed regulatory filings with the SEC further indicate that upon redemption, customers are entitled to distributions of cash, not distributions of any of the securities in the applicable segregated portfolio.

THE BONY ACCOUNT STRUCTURE

29. BONY, as Sentinel's custodian bank, established a series of accounts for each of the three customer SEG pools which supposedly mirrored Sentinel's customer pools.

30. As required by federal law, BONY entered into a series of letter agreements with Sentinel specifying that the funds deposited by Sentinel's customers would be segregated from customers in other SEGs and from Sentinel's own funds. Segregation letters were executed with respect to each of SEG 1, 2 and 3.

31. BONY established segregated cash accounts for U.S. denominated funds that were supposed to be held for Sentinel's customers in SEGs 1, 2 and 3, respectively.

32. BONY also established segregated securities accounts for government and government agency securities (hereinafter collectively referred to as "government securities"), such as U.S. Treasury notes, Fannie Mae and Ginnie Mae notes that were supposed to be held for Sentinel's customers in SEGs 1, 2, and 3, respectively.

33. However, BONY improperly established a single, non-segregated clearing account for all government securities transactions. Thus, all purchases and sales of government securities had to be processed through this single account, whether they were on behalf of SEGs 1, 2 or 3 or Sentinel itself.

34. BONY also improperly established this government securities clearing account as the account in which BONY's extensions of credit to Sentinel, whether in the form of daytime "overdrafts" or overnight loans, were booked. (Hereafter, this account is referred to in this Complaint as the "Clearing/Collateral Account.") Thus, whenever securities were sold using this account and whenever customer funds were transferred to this account, those funds automatically went to reduce the daytime overdraft position associated with this Clearing/Collateral Account.

35. BONY also established three segregated securities accounts that were supposed to hold DTC-registered corporate securities for Sentinel's customers in SEG 1, SEG 2 and SEG 3, respectively.

36. BONY also established a DTC clearing account, also known as the "FC1 account" or the "Street Securities Account" ("the DTC Clearing Account" hereafter) to clear both customer and House transactions in DTC-registered securities. Just like the Collateral/Clearing Account, however, the DTC Clearing Account was not a segregated account.

37. The DTC Clearing Account was not used for cash transactions. Cash deposits, withdrawals and settlement payments relating to DTC corporate transactions were processed in the Clearing/Collateral Account.

38. A similar account structure also was established by BONY for securities registered with Euroclear.

39. Sentinel also had cash accounts for SEGs 1, 2 and 3 at JP Morgan. Those accounts were supposed to hold cash associated with customer accounts.

40. As explained below, the BONY account structure did not in fact result in any segregation of customer funds, but rather promoted and led to commingling and misappropriation of such funds by Sentinel and BONY.

SENTINEL AND BONY'S MASSIVE COMMINGLING AND TREATMENT OF ALL ASSETS UNDER MANAGEMENT AS PART OF A SINGLE UNDIFFERENTIATED POOL

41. Despite their regulatory obligations and the promises to Sentinel's customers, Sentinel and BONY did not in fact segregate customer assets for customers of SEGs 1, 2 or 3 at any relevant time. Instead, Sentinel, aided and abetted by BONY, engaged in a massive scheme to commingle and misuse customer assets of all customer SEGs as if they were part of a single undifferentiated pool of assets, which also included Sentinel's own funds. While Sentinel attempted to create the false appearance of segregation, in fact, all assets managed by Sentinel were treated as a single pool belonging to Sentinel itself.

42. This commingling and pooling of customer assets began in earnest when Sentinel fundamentally changed its operations in about 2003. Prior to that Sentinel had purchased only high-grade securities and did not have a significant House portfolio. The BONY loan was used only to assist in providing immediate liquidity to customers. In about 2003, however, the Sentinel insiders embarked on a different program, establishing a House portfolio, buying illiquid, higher-risk and higher-return securities, and using repurchase agreements and the BONY loan as leverage to finance the purchase and control of income associated with massive amounts of securities.

43. In a typical repurchase or "repo" transaction, the repo borrower (in this case Sentinel) acquires and transfers a security to a repo lender, which in turn makes a repo "loan" to Sentinel and holds the security as collateral.

44. Repo counterparties imposed a "haircut" on the amount loaned to Sentinel in order to provide a sufficient collateral cushion above market value to satisfy Sentinel's repo

obligations in the event of a default. Thus, a repo lender advanced to Sentinel, for example, only 90% of the current market value of the security subject to the repo transaction (a 10% "haircut").

45. Absent a default, the repo borrower (here Sentinel) typically is entitled to all income generated by the security, and thus Sentinel could control all income associated with the security while only paying the haircut (essentially acquiring the security on "margin").

46. Because Sentinel had virtually no capital, the Sentinel Insiders financed the net acquisition cost for securities that were the subject of repo transactions (*i.e.* the haircut) using Sentinel's overnight loan facility with BONY. As the number of securities positions controlled by Sentinel grew, the loan ballooned. Customers were not advised, however, of even the existence of the loan, let alone that the loan was being secured with securities that were supposed to be segregated.

47. This leveraging scheme and the BONY account structure led to the commingling of customer funds from the day they were deposited.

48. Specifically, when a customer in SEGs 1, 2 or 3 deposited funds, those funds initially were deposited by the customer into the corresponding segregated cash account at BONY. However, at the end of each day, any funds remaining in those accounts, after they were used to pay redeeming customer withdrawals (if any), were swept into the BONY Clearing/Collateral Account.

49. There was always a significant negative cash balance in the Clearing/Collateral Account as a result of BONY's huge overnight loans to Sentinel, which were converted into daytime overdrafts each day. For instance, throughout 2007, the daytime overdraft in the Clearing/Collateral Account was always well in excess of $200 million, was often over $300 million, and sometimes exceeded $500 million. Thus, when customer funds that had been

deposited during the day were, at day's end, swept into the Clearing/Collateral Account, they automatically went to pay down the overdraft in the account. In short, those funds, which were supposed to be segregated for the benefit of the customers, disappeared.

50. Thus, for example, on March 16, 2007, the SEG 1 Account at BONY had a beginning balance of $1.5 million. Farr then deposited $2.6 million to the SEG 1 Account. Other customers in SEG 1 deposited $38.4 million. Additionally, approximately $38.6 million had been transferred into SEG 1 by Sentinel at the beginning of the day to provide a cushion for customer redemption during the day. Thus, a total of about $81.1 million was in the SEG 1 cash account following the SEG 1 customer deposits. Of that amount, approximately $77.9 million was disbursed to other customers who redeemed portions of their accounts during the day or to Sentinel, leaving a balance of $3.2 million in the account. At the end of the day, the entire $3.2 million (less about $14,000) including everything left of Farr's deposits, was swept into BONY's Clearing/Collateral Account. Those funds immediately went to reduce the overdraft balance in the Collateral/Clearing Account, which by this time was greatly in excess of $200 million negative at all times. Thus, Farr's deposit of $2.6 million went to pay out other redeeming SEG 1 customers and to reduce Sentinel's overdraft balance. None of the funds deposited were used to purchase any securities.

51. Sentinel did control more than two billion dollars in face value of securities, some of which it represented to customers as being held for the benefit of particular SEGs. However, those securities were in fact purchased using the proceeds of the BONY loan and repo agreements. BONY's loan was not made to specific customer SEGs; indeed, the customers did not even know that the loan existed. Instead, the loan was made to Sentinel itself. Thus, if anyone owned these securities, it was Sentinel itself, not the customers.

52. Sentinel's loan, in turn, was secured with certain securities which it falsely told the customers belonged to specific customers and were held in segregation. In actuality, to secure the BONY loan Sentinel arbitrarily transferred into or left in the BONY Clearing/Collateral Account whatever securities were at hand and were necessary to make sure BONY was fully collateralized, without regard to segregation and without regard to whom those assets supposedly belonged. At all times after 2005, hundreds of millions of dollars in securities that were supposed to be segregated were instead pledged to support Sentinel's obligations to BONY. And, as explained below, in the summer of 2007, to secure the BONY loan Sentinel and BONY freely moved huge blocks of supposedly segregated securities into and out of the BONY Clearing/Collateral Account, as well as the DTC Clearing Account, without regard to who supposedly owned the securities or who benefited from the loan.

53. Moreover, the Sentinel insiders' representations to customers about the assignment or allocation of specific securities to their SEG was a complete fabrication. In fact, Sentinel treated all of the more than $2 billion in securities it controlled as part of a single pool. At the end of each business day, Sentinel would refer to the securities in that undifferentiated pool and assign or "allocate" certain securities to customer SEGs, but solely for purpose of reporting to customers.

54. The securities so "allocated" were not necessarily segregated for the customers of that SEG. Often the securities that were "allocated" to customers were not segregated at all — they were instead held in BONY's unsegregated Clearing/Collateral Account or the unsegregated DTC Clearing Account and thus already pledged to secure BONY's loan.

55. In addition, securities that were reported on customer statements as being segregated for the benefit of one SEG were sometimes actually being held at BONY in the account of a different SEG.

56. Moreover, many securities were reported on both SEG 1 and SEG 3 customer statements, in various shifting percentages, as belonging to each SEG, but those securities were not actually segregated in proportion to those assignments.

57. Further, interest and other income generated by the securities and assigned to customers on their statements was not determined or allocated on the basis of securities actually held in a particular SEG or even on the basis of what securities were reported on customer statements as belonging to that customer. Rather, the interest reported on customer statements was created by determining the total interest earned that day on Sentinel's entire portfolio, deducting from that figure the amount needed to pay interest on BONY's loan, interest to repo counterparties and Sentinel's management fees, and then artificially dividing the remainder up among customers based on the Insiders' subjective perception of what putative interest rate would satisfy particular customers.

58. As a result of the foregoing scheme, SEG 1 customer account statements reflected interest attributable to securities that were not allocated to SEG 1, and SEG 1 customer account statements in the aggregate were and are overstated by millions of dollars.

59. In short, in every relevant way, Sentinel dealt with all securities it managed as part of an undifferentiated pool belonging to Sentinel itself. The cash deposited by customers was not used to buy securities, but to reduce the BONY loan. The customer statements, on which Farr and certain other customers base their claims, were prepared for the sole purpose of creating for customers the false appearance that there were securities segregated for their benefit

that equaled the total of their investments plus interest supposedly earned on those investments. Securities were not segregated, and the investment returns were false.

SUMMER OF 2007: SENTINEL AND BONY MOVE "SEGREGATED" ASSETS INTO AND OUT OF THE CLEARING/COLLATERAL ACCOUNT

60. For the reasons explained above, at all times the securities supposedly owned by the customer SEGs were never their property. The events of the summer of 2007 clearly demonstrate that both Sentinel and BONY, the parties with the duty to segregate assets, did not treat these assets as belonging to customers at all, but rather as belonging to Sentinel.

61. Many of the securities that Sentinel's insiders purchased during the 2004 - 2007 time-period were acquired using repurchase agreements under which repo counterparties such as Fimat and Cantor Fitzgerald lent money to Sentinel to finance most of the acquisition costs of the securities, with the balance (the "haircut") financed by BONY. Many of the securities that were the subject of those repo agreements were illiquid, highly-structured investments and not the subject of material secondary market trading, and many (the physical securities) were not even registered in the DTC system.

62. The BONY loan used to finance the haircut on securities controlled under repo agreements increased dramatically over time, rising from $55 million at the end of 2003 to over $253 million at the beginning of May 2007. As indicated above, to secure the BONY loan Sentinel arbitrarily transferred into or left in the BONY Clearing/Collateral Account whatever securities were at hand and were necessary to make sure BONY was fully collateralized, without regard to segregation and without regard to who these assets supposedly belonged. As of early May 2007, more than $325 million in securities (par value) that were supposed to be segregated for the benefit of SEG 1 and SEG 3 customers actually were in the Clearing/Collateral Account or other unsegregated accounts supporting the BONY loan.

63. As of May 2007, Sentinel had incurred over $2.4 billion in obligations to repo counterparties in order to control securities with a value purportedly exceeding that amount. As the credit market tightened in the spring and summer of 2007, repo counterparties began to refuse to continue to finance lower-grade securities received from Sentinel under repo agreements, increasing their margin (haircut) requirements or simply refusing to continue to engage in repo transactions in such securities.

64. At the end of May 2007, Fimat became the first major Sentinel repo counterparty to refuse to continue financing certain securities. Fimat closed out the repo transactions related to certain high-risk securities, and returned more than $100 million (face value) in securities to Sentinel through the BONY clearing system. Pursuant to its repo agreements with Fimat, Sentinel was obliged to pay its repo obligation to Fimat or risk a default. Because Sentinel could not finance its repo payment to Fimat in any other way, on June 1, 2007, it borrowed an additional $94 million from BONY, increasing the BONY total loan balance to more than $353 million.

65. To secure the increased loan, on June 1, Sentinel and BONY moved large blocks of government securities from both the SEG 1 and SEG 3 segregated government securities accounts, with a face value of almost $87 million, into the unsegregated Clearing/Collateral Account (the "June 1 Transfers"). These transfers took place at the end of the day and did not coincide with any large customer redemptions or other potentially legitimate customer transactions. They also were made without regard to whether the securities returned by Fimat were "allocated" to SEG 1, SEG 3, the House, or no one at all (indeed, <u>none</u> of the securities returned by Fimat were supposed to belong to SEG 1 or SEG 3). After this transfer, less than

$15 million (face value) of government securities remained in the SEG 1 segregated government securities account.

66. On June 25, 2007, Fimat informed Sentinel that it would no longer finance an additional batch of securities through repo agreements, and returned another $140 million (face amount) in securities to Sentinel's physical account at BONY. As a result, Sentinel was again obligated to repay Fimat under its repo agreements with Fimat. In order to do so, it once again borrowed additional funds from BONY using assets that were supposed to be segregated as collateral.

67. On June 26, 2007, Sentinel and BONY transferred virtually all of the remaining government securities in the SEG 1 and SEG 3 segregated government securities accounts, totaling in excess of $66 million in face value, into the Clearing/Collateral Account. Again, these securities were transferred without regard to whether the physical securities returned by Fimat — which caused the increase in the loan — had any relationship to SEGs 1 and 3.

68. After this transfer, there were no government securities in the SEG 1 government securities account, and only $15,000 face value of government securities in the SEG 3 government securities account. By this date, of some $463.6 million in face value of government securities held at BONY in connection with the Sentinel accounts, $463.1 million – more than 99% of all of Sentinel's government securities – were being held in the Clearing/Collateral Account for the benefit of BONY, not in segregated customer accounts.

69. At the close of business on June 29, 2007, Sentinel was still short $145 million in collateral. In order to fully collateralize the loan, Sentinel and BONY moved approximately $170 million in face value of corporate securities from the SEG 1 DTC account, representing one-half of the total value of that account, and transferred them into the DTC Clearing Account

to be used as collateral for the BONY loan. Again, there was no connection between the loan increase and the source of the assets used to secure the loan.

70. On July 17, the loan increased to almost $497 million when another repo counterparty, Cantor Fitzgerald, closed out over $150 million (face amount) in repo positions with Sentinel. Sentinel and BONY again moved customer securities from the segregated SEG 1 DTC account into the DTC Clearing Account, this time more than $84 million in face value of DTC securities. There again was no connection between the securities returned and the same source of the assets used to secure the loan.

THE LOOTING OF SEG 3 "SEGREGATED" ACCOUNTS
FOR THE BENEFIT OF SEG 1 CUSTOMERS

71. As of the open of business on July 30, at a time when Sentinel was reporting more than $655 million in customer balances attributable to SEG 1, only $84.6 million in cash and securities (par value) remained in accounts denominated as segregated SEG 1 accounts. Thus, as of that date, less than 15% of all securities supposedly segregated and attributable to SEG 1 were actually held in segregated accounts, and instead more than 85% had been misappropriated and were being used to support the BONY loan.

72. On about July 30, Sentinel's chief financial officer supposedly determined that assets attributable to SEG 1 customer accounts should not be used as collateral for the bank loan. Sentinel then began a program, with BONY's assistance, to move huge blocks of some (but not all) of the securities serving as BONY collateral into SEG 1 accounts. In order to ensure that BONY was fully collateralized on its loan, however, Sentinel and BONY undertook this program at the direct expense of Sentinel's SEG 3 customers and took from SEG 3 segregated accounts essentially all remaining putative SEG 3 customer assets that had not already been pledged for the BONY loan.

73. Specifically, on July 30, Sentinel and BONY moved $248 million (face value) in securities out of the DTC Clearing Account, where they had been used as collateral for the loan, and transferred them to the SEG 1 DTC account. On the following day, July 31, Sentinel and BONY moved $264 million (face value) in government securities, which had been sitting in the Clearing/Collateral Account, from that account to the SEG 1 government securities account.

74. The transfer of over $500 million (face value) of securities to SEG 1 accounts over this two-day period would have created a gaping shortfall in BONY's collateral position. In order to plug that hole, on July 30 Sentinel and BONY took $289 million (face value) of securities from the segregated SEG 3 DTC account and moved them to the DTC Clearing Account, where they were posted to the Clearing Collateral account as security for Sentinel's loan. This action virtually emptied the SEG 3 DTC account, leaving only $900,000 (face value) of DTC registered securities in a segregated account which for months had consistently held more than $250 million (face value) worth of securities.

THE REDEMPTION FREEZE AND SENTINEL'S POST-FREEZE DISTRIBUTIONS TO SEG 1 CUSTOMERS

75. For the next two weeks, Sentinel's insiders juggled and in some cases delayed customer redemption demands. They allocated large numbers of securities to customer accounts that did not comply with customer investment specifications, and with respect to many of those securities could not and should not have allocated them at all because they already were serving as collateral for the BONY loan in unsegregated accounts. During this time period, the insiders continued to encourage customers to invest at Sentinel.

76. On August 13, 2007, Sentinel issued a letter to customers stating that redemptions had been suspended.

77. As of the close of business on August 13, 2007, the accounts denominated as SEG 1 accounts at BONY and JP Morgan held a total of $329,434,685.55 (sale value)[1] in securities and $672,467.64 in cash, for a total of $330,107,153.19. Of that amount, however, $20,044,033.11 in securities did not appear on SEG 1 customer statements and supposedly were allocated to SEG 3 customers. Thus, the total amount in SEG 1 segregated accounts and arguably available to pay SEG 1 customers was only $310,063,120.08. As further explained below, SEG 1 customers received far in excess of that amount in distributions over the following eight days.

78. On August 14, Sentinel took $112,110,000 out of the SEG 3 cash account at JP Morgan and moved it to the SEG 1 cash account at JP Morgan.

79. On August 15, four SEG 1 customer accounts — Alaron Trading, Iowa Grain, Crossland and Trade Maven — were fully redeemed by Sentinel with payments totaling $111,229.456.41. The bulk of the payouts to those four SEG 1 customers, $90,252,057.81, came from the funds that had been taken from the SEG 3 account the day before. The balance of the payouts to these customers, $21,079,398.60, were the proceeds from the close out of a SEG 1 reverse repo position the day before.

80. On August 16, 2007, Sentinel entered into an agreement with Citadel Equity Fund, Ltd. and Citadel Limited Partnership to sell the purported SEG 1 portfolio to Citadel, and thereafter consummated that sale. Some of these securities sold to Citadel were not held in segregated accounts but appeared on the August 13 statements of SEG 1 customers. Others were held in SEG 1 accounts but were attributed to SEG 3 customers, not SEG 1 customers, on

[1] This sale value is (i) with respect to securities that were the subject of reverse repo agreements, the proceeds delivered by repo counterparties in exchange for delivery of the securities, (ii) with respect to securities sold to Citadel, the amount realized by Sentinel from Citadel after taking into account the "market uncertainty concession" fee assessed by Citadel, and (iii) with respect to any other securities, the proceeds realized by the Trustee.

customer statements. Citadel paid Sentinel $318,661,126.65 for the securities it acquired.[2] Of this amount, only $302,469,728.88 was credited to the SEG 1 account at BONY; the other $16,191,397.77 was credited to a Euroclear account at BONY, over which BONY claims it has a lien and which funds could not be used to make distributions. None of the Citadel proceeds were credited to SEG 3 accounts.

81. On August 17, $22,524,942.18, the remainder of the funds which had been taken from the SEG 3 cash account on August 14, was distributed to or for the benefit of customers in SEG 1.

82. Later on August 17, Sentinel filed a petition under Chapter 11 of the Bankruptcy Code.

83. On the same date, certain temporary restraining orders enjoining the distribution of funds were entered by the United States District Court for the Northern District of Illinois and by the Circuit Court of Cook County, Illinois.

84. As a result of the temporary restraining orders, BONY refused to distribute the proceeds of the Citadel sale to SEG 1 customers. Sentinel, as debtor-in-possession, through its bankruptcy counsel, then filed an emergency motion for approval of turnover and distribution of assets, which was heard by Judge John H. Squires on August 20.

85. At the hearing, Sentinel's bankruptcy counsel represented it was undisputed that the Citadel proceeds were not property of the estate: "I believe there is no disagreement with the fact that the funds are not property of the estate and the funds belong in the hands of the SEG 1 customers." Counsel further contended, "we have got $312 million of money that belongs to somebody else. It doesn't belong to us. It belongs to the customers." Counsel also stated,

[2] An additional $1,263,349.20 was received by Sentinel that day, a portion of which may be attributable to securities sold to Citadel. That amount was not credited to any Sentinel account, and instead was used to reduce the outstanding BONY loan balance that day.

"What is in there is not property of the estate. It is the property of the debtor's customers," and concluded, the "narrow issue that's before this court is whether funds that do not belong to the estate should be distributed to the people who own them." On this basis, Sentinel's counsel argued that BONY should distribute the Citadel proceeds to SEG 1 customers.

86. These representations by counsel were demonstrably incorrect. This was not due to any fault of counsel – he simply could not have uncovered in three days what it took the Trustee, his counsel, and forensic accountants far longer to understand. In particular, counsel was wholly unaware that (a) Sentinel insiders had misappropriated what were supposed to be customer assets to secure a loan to Sentinel; (b) the customer account statements reflecting segregation were fictitious and were contradicted by numerous other records; (c) cash deposited by customers was used to pay down the BONY loan and disappeared the day it was deposited; (d) securities allocated to customers were not purchased with cash deposited by them; (e) the securities controlled by Sentinel were essentially all financed by the BONY loan and repos; (f) hundreds of millions of dollars in securities reported as being segregated were maintained in non-segregated accounts and pledged as collateral for Sentinel's loan; (g) a number of securities reported on customer statements as being held in one SEG account were actually maintained in a different SEG account at BONY; (h) in July, $500 million in securities were shifted from the Clearing/Collateral Account to a SEG 1 account and replaced by $300 million in securities from SEG 3 accounts; (i) three days before the bankruptcy filing, Sentinel shifted over $100 million from a SEG 3 cash account to a SEG 1 cash account; or (j) Sentinel had paid out $111 million to four SEG 1 customers on August 15, most of which was taken from the SEG 3 cash account.

87. There was no evidentiary presentation concerning the assertion that the Citadel proceeds belonged to the SEG 1 customers, not the estate. Accordingly, the Court was required

to rely on the assertions of bankruptcy counsel and stated, "What is clear is that the subject underlying property or the proceeds, if you will, apparently is not considered to be property of the Chapter 11 debtor in possession's estate." However, the Court expressly stated that issues regarding property of the estate had to be decided in an adversary proceeding and "[a]re reserved for another day." The Court expressly rejected the proposal that it direct BONY to disburse the funds and deleted from the proposed order a directive to BONY that it "shall" distribute the funds and substituted instead the permissive "may." The August 20, 2007 order merely gave BONY comfort that it would not violate the three extant TROs by distributing the proceeds and is expressly without prejudice to any claims and causes of action, including avoidance actions, by the Trustee. The August 20, 2007 order also was conditioned on BONY and Sentinel not distributing and holding back $15.6 million of the Citadel proceeds.

88. On August 21, $297,050,808.26 was distributed to or for the benefit of SEG 1 customers. This represented all but $5.4 million of the $302,469,728.88 in Citadel proceeds that had been credited to the SEG 1 account at BONY and arguably available for distribution to SEG 1 customers. Both BONY and Sentinel failed to hold back $15.6 million as had been ordered by the Court as a precondition to distributions to SEG 1 customers.

89. Thus, in the eight-day period following August 13, SEG 1 customers received cash distributions totaling $430,805,206.84 (representing the payouts described in paragraphs 79, 81 and 88 above).

90. The $430,805,206.84 distributed to or for the benefit of SEG 1 customers was far in excess — $120,742,086.76 in excess to be precise — of any assets which SEG 1 customers could arguably claim were segregated on their behalf and identified on SEG 1 customer statements on August 13, the date of their last customer statements. The amount distributed was

hundreds of millions of dollars more than the assets segregated in SEG 1 accounts on July 30, the day that all of SEG 3's DTC securities were swapped for supposed SEG 1 securities that were released from collateral accounts and moved to SEG 1 securities accounts.

91. Farr received $10,834,503 of the funds distributed to SEG 1 customers after August 13, far in excess of its share of the assets it claims were segregated for its benefit in the SEG 1 accounts and reflected on Farr's customer statements.

92. Farr and certain other SEG 1 customers contend that tracing rules should apply, and that the SEG 1 customer accounts of Alaron, Iowa Grain, Crossland and Trade Maven (the SEG 1 customers paid out on August 15 largely using funds taken from the SEG 3 cash account at JP Morgan), should be excluded for purposes of determining whether SEG 1 customers received overpayments. There is no basis to exclude certain SEG 1 customers and the payments they received for purposes of computing the total distributions received by SEG 1 customers. But even accepting this theory and excluding the four customers, the remaining SEG 1 customers (including Farr) who received $319,575,750.44 on August 17 and August 21 were still paid almost $31 million more than they were entitled to:

Assets in SEG 1 denominated accounts on and after Aug. 13 and reflected on SEG 1 customer statements:	$310,063,120.08
Less proceeds realized from securities reflected on account statements of four SEG 1 customers paid on August 15:	($21,079,398.60)
Net assets in SEG 1 denominated accounts on and after Aug. 13 and reflected on remaining Seg 1 customer statements:	$288,983,721.48

93. There is currently only $36.4 million (not $40 million) held in accounts denominated as SEG 1, all in cash. Only $5 million is the proceeds of a security that was held in a SEG 1 segregated account and reflected on customer account statements as attributable to

remaining SEG 1 customers. $9,904,944.13 is the proceeds from sales of securities that were attributable on customer statements to SEG 3 customers, and the balance consists of the proceeds of securities attributable to the four customers paid in full on August 15, whose assets and accounts Farr claims should be excluded from the calculation of SEG 1 customer payments (and if tracing were to be applied, could not be traced to Farr's account in any event), as well as a few hundred thousand dollars in accrued interest and/or coupon payments. Thus, even if it were appropriate to trace funds and securities, Farr already has received far more than it is entitled to, no matter the methodology used.

94. All these calculations assume, of course, that the approximately $310 million in assets in SEG 1 on August 13 and reflected on SEG 1 account statements actually were the property of SEG 1. As previously explained, none of that property ever actually belonged to SEG 1 as a result of the commingling and pooling of assets and was, in reality, property of the estate. Moreover, almost none of that property was even segregated in accounts called SEG 1 until shortly before the redemption freeze. Indeed, prior to the massive swap of securities in SEG 1's favor on July 30 and 31 — only two weeks before the redemption freeze — the SEG 1 segregated accounts contained securities with a total face value of only about $84 million and cash of only about $673,000.

COUNT I

(AVOIDANCE AND RECOVERY OF POST-PETITION TRANSFERS)

95. The Trustee restates and realleges Paragraphs 1 through 94 as though fully set forth herein.

96. Sentinel transferred $10,070,845 to or for the benefit of Farr on or about August 21, 2007 ("the Post-Petition Transfer").

97. The Post-Petition Transfer was a transfer of property of the estate.

98. The Post-Petition Transfer was made after the Petition Date.

99. The Post-Petition Transfer was not authorized under the Bankruptcy Code.

100. The August 20 Order did not authorize the Post-Petition Transfer pursuant to § 549 of the Bankruptcy Code.

101. In the alternative, the Court's August 20 Order should be vacated or revoked under Rule 60(b) of the Federal Rules of Civil Procedure based on mistake and newly discovered evidence. Specifically, the Court's August 20 Order was premised on the assertion that the proceeds of the securities sold to Citadel did not constitute property of the estate.[3]

102. Pursuant to § 550(a) of the Bankruptcy Code, the Post-Petition Transfer may be recovered from the Defendant as the initial transferee of such transfer or the entity for whose benefit such transfer was made.

WHEREFORE, the Trustee respectfully requests pursuant to 11 U.S.C. §§ 549(a) and 550 that the Court:

A. Enter judgment in favor of the Trustee and against the Defendant avoiding the Post-Petition Transfer;

B. Enter judgment in favor of the Trustee and against the Defendant in the amount of the Post-Petition Transfer, plus pre and post-judgment interest, fees and costs to the extent provided by law; and

C. Grant the Trustee such further and other relief as the Court may deem equitable and just.

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[3] The Trustee has filed in the bankruptcy case a Motion to Clarify or in the Alternative to Vacate or Modify the Court's August 20, 2007 Order [Docket No. 978].

COUNT II

(AVOIDANCE AND RECOVERY OF PREFERENTIAL TRANSFERS)

103. The Trustee restates and realleges Paragraphs 1 through 94 as though fully set forth herein.

104. During the ninety (90) day period before to the Petition Date, notwithstanding the liquidity crisis at Sentinel and the other matters set forth herein, Defendant continued to receive redemption payments from Sentinel.

105. In addition, even after the August 13 redemption freeze, Defendant received its share of the August 17 transfer of $22,524,942.18 to SEG 1 customers.

106. Within ninety (90) days prior to the Petition Date, the Debtor transferred property in which it had an interest, as set forth in Exhibit A hereto (collectively, the "Preferential Transfers"), to or for the benefit of Defendant.

107. The Preferential Transfers were made to a creditor of the Debtor.

108. With respect to each of the Preferential Transfers, the Debtor made such Preferential Transfers on account of an antecedent debt owed by the Debtor before each of the Preferential Transfers was made.

109. Each of the Preferential Transfers was made while the Debtor was insolvent.

110. Each of the Preferential Transfers enabled such creditor to receive more than it would have received if this case was a case under Chapter 7 of the Bankruptcy Code, the Preferential Transfers had not been made, and such creditor received payment of its debt to the extent provided by the provisions of the Bankruptcy Code.

111. The Defendant also may have received additional preferential transfers which may be discovered during the discovery process.

112. The Preferential Transfers may be avoided under § 547(b) of the Bankruptcy Code.

113. After taking into account all new value given to the Debtor by such creditor after each of the Preferential Transfers, to the extent not secured by an otherwise unavoidable security interest and on account of which new value the Debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor (the "new value" defense under § 547(c) of the Bankruptcy Code), the Trustee may avoid $3,613,658 of the Preferential Transfers, including the $763,658 paid to or for the benefit of Defendant on August 17 (the "Net Avoidable Transfers").

114. Pursuant to § 550(a) of the Bankruptcy Code, the amount of the Net Avoidable Transfers may be recovered from the Defendant.

WHEREFORE, the Trustee respectfully request pursuant to 11 U.S.C. §§ 547(b) and 550 that the Court:

A. Enter judgment in favor of the Trustee and against the Defendant avoiding the Net Avoidable Transfers;

B. Enter judgment in favor of the Trustee and against the Defendant in the amount of the Net Avoidable Transfers, plus pre and post-judgment interest, fees and costs to the extent provided by law; and

C. Grant the Trustee such further and other relief as the Court may deem equitable and just.

COUNT III

(DECLARATORY JUDGMENT CONCERNING INTEREST IN PROPERTY)

115. The Trustee restates and realleges Paragraphs 1 through 94 as though fully set forth herein.

116. The Defendant asserts that the cash held by the Trustee in the account denominated as a SEG 1 account, as set forth in paragraph 93 above, is not property of the estate.

117. The Defendant asserts that it holds an interest in the cash held by the Trustee in the account denominated as a SEG 1 account, and that it is entitled to its proportionate share thereof.

118. The Defendant also asserts that it holds an interest in cash held in accounts denominated as SEG 2 or SEG 3 accounts, and that it is entitled to its proportionate share thereof.

119. An actual controversy exists between the Trustee and Defendant within the meaning of 28 U.S.C. § 2201 regarding (a) whether the cash held by the Trustee in the account denominated as a SEG 1 account is property of the Debtor's estate under § 541 of the Bankruptcy Code, (b) whether the Defendant holds an interest in the cash held by the Trustee in the account denominated as a SEG 1 account, and is entitled to its proportionate share thereof, and (c) whether the Defendant holds an interest in the cash held by the Trustee in any accounts denominated as SEG 2 or SEG 3 accounts, and is entitled to its proportionate share thereof.

WHEREFORE, the Trustee respectfully requests that the Court:

A. Declare that all of the cash held by the Trustee in accounts denominated as SEG 1, SEG 2 or SEG 3 accounts is property of the Debtor's estate under § 541 of the Bankruptcy Code;

B. Declare that any other assets held or controlled by the Debtor or Trustee or in which the Debtor or Trustee has an interest, in which the Defendant asserts an interest, are property of the Debtor's estate under § 541 of the Bankruptcy Code; and

C. Grant the Trustee such further and other relief as the Court may deem equitable and just.

COUNT IV

(DISALLOWANCE OF CLAIMS)

120. The Trustee realleges and restates Paragraphs 1 through 119 as though fully set forth herein.

121. Pursuant to § 502(d) of the Bankruptcy Code, the Court shall disallow any claim of any entity from which property is recoverable under §§ 542, 543, 550 or 553 of the Bankruptcy Code or that is a transferee of a transfer avoidable under §§ 552(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of the Bankruptcy Code, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under §§ 522(i), 542, 543, 550, or 553 of the Bankruptcy Code.

122. Because the Defendant has not turned over to the Trustee the Post-Petition Transfer and Net Avoidable Transfers, the Court must disallow under § 502(d) of the Bankruptcy Code any claims of the Defendant against the Debtor until the Defendant pays to the Trustee the value of such transfers.

WHEREFORE, the Trustee respectfully requests pursuant to 11 U.S.C. § 502(d) that the Court:

A. Disallow any claims of the Defendant against the Debtor pursuant to § 502(d) of the Bankruptcy Code; and

B. Grant the Trustee such further and other relief as the Court may deem equitable and just.

Dated: September 15, 2008

Respectfully submitted,

FREDERICK J. GREDE, not individually but as Chapter 11 Trustee of Sentinel Management Group, Inc.

By: */s/ Vincent E. Lazar*
One of his attorneys

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Exhibit A

Sentinel Management Group, Inc.
Summary Of Customer Withdrawals During The 90 Day Period Prior To And Including August 17, 2007
Farr Financial, Inc. (All Accounts) [(1)]

Transaction Data					
Account	**Number**	**ID**	**Description**	**Date**	**Amount**
FFI001-USD-001	325304	WIRE	Wire Transfer to Harris FBO Farr	5/21/2007	$ (550,000)
FFI001-USD-001	325576	WIRE	Wire Transfer to Harris FBO Farr	5/22/2007	(100,000)
FFI001-USD-001	329467	WIRE	Wire Transfer to Harris FBO Farr	6/11/2007	(1,100,000)
FFI001-USD-001	330358	WIRE	Wire Transfer to Harris FBO Farr Financial Customer	6/14/2007	(650,000)
FFI001-USD-001	330645	WIRE	Wire Transfer to Harris FBO Farr	6/15/2007	(700,000)
FFI001-USD-001	330652	WIRE	Wire Transfer to Harris FBO Farr	6/15/2007	(200,000)
FFH001-USD-001	330915	WIRE	Wire Transfer to Harris FBO Farr Financial House Account	6/18/2007	(100,000)
FFI001-USD-001	332650	WIRE	Wire Transfer to Harris FBO Farr	6/26/2007	(250,000)
FFI001-USD-001	332927	WIRE	Wire Transfer to Harris FBO Farr	6/27/2007	(150,000)
FFI001-USD-001	336646	WIRE	Wire Transfer to Harris FBO Farr	7/17/2007	(400,000)
FFI001-USD-001	336913	WIRE	Wire Transfer to Harris FBO Farr	7/18/2007	(300,000)
FFI001-USD-001	337982	WIRE	Wire Transfer to Harris FBO Farr	7/24/2007	(500,000)
FFI001-USD-001	338777	WIRE	Wire Transfer to Harris FBO Farr	7/27/2007	(700,000)
FFI001-USD-001	339077	WIRE	Wire Transfer to Harris FBO Farr	7/30/2007	(500,000)
FFI001-USD-001	340838	WIRE	Wire Transfer to Harris FBO Farr	8/7/2007	(450,000)
FFI001-USD-001	342934	WIRE	Wire Transfer to Harris FBO Farr	8/17/2007	(763,658)

Note(s):

(1) FFI001-USD-001 (Farr Financial, Inc.) is a Seg 1 account. FFH001-USD-001 (Farr Financial House Account) is a Seg 3 Account. FFF001-USD-001 (Farr Financial Forex Customer Funds) is a Seg 3 account which did not have withdrawals during the 90 day period prior to and including August 17, 2007.