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IN THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IN RE: BERNARD L. MADOFF INVESTMENT SECURITIES LLC

On Appeal from the United States Bankruptcy Court
for the Southern District of New York

BRIEF OF APPELLEE SECURITIES INVESTOR PROTECTION CORPORATION

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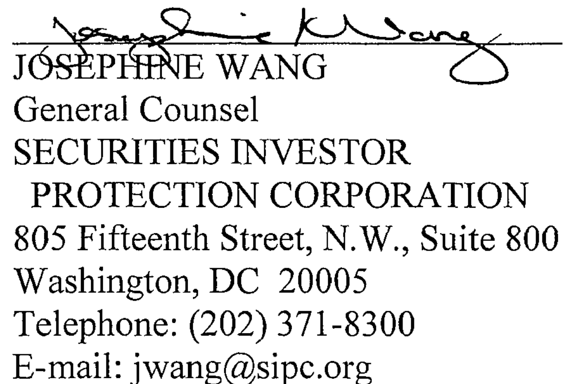
Washington, D.C.

CORPORATE DISCLOSURE STATEMENT

In accordance with Rule 26.1(a) of the Federal Rules of Appellate Procedure, the Securities Investor Protection Corporation hereby states that it has no parent corporation and there is no publicly held corporation owning 10% or more of stock in the Securities Investor Protection Corporation.

Dated: September 20, 2010
Washington, DC



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This appeal arises in the context of a liquidation proceeding under the Securities Investor Protection Act, 15 U.S.C. §78aaa et seq. ("SIPA").[1] Under SIPA section 78eee(d), the Securities Investor Protection Corporation ("SIPC") is deemed to be a party in interest as to all matters arising in a SIPA proceeding, with the right to be heard on all such matters. SIPC submits this brief in support of the position of the Trustee in this case ("Trustee").

STATEMENT OF THE ISSUE

Where 1) SIPA protects the customers of a failed securities brokerage against the loss of cash and securities custodied by the customer with the broker; 2) the only property deposited by the customer with the broker is cash for the purpose of buying securities; 3) the broker converts the customer's cash and issues fake account statements to the customer; 4) the customer relies solely upon the fake account statements in claiming the value of fake securities positions appearing on the statements; and 5) the customer, under SIPA, must prove that the broker's obligation to him is supported by the broker's books and records, and if not, prove his claim to the satisfaction of the trustee,

> whether the trustee properly considers the net amount of cash deposited by the customer to be the amount owed by the broker to the customer (that is, his "net equity" under SIPA), inasmuch as SIPA provides that claims are to be determined not according to account statements alone but according to the broker's books and records, and the books and records show that the fake securities positions relied upon by the investors were invented by the broker based on backdated prices in order to yield "profits" that the broker predetermined.

SIPC submits that in these circumstances, the customer's net equity is the net amount deposited by the customer with the broker.

[1] References hereinafter to provisions of SIPA shall omit "15 U.S.C."

STATEMENT OF THE CASE

This is an appeal from an order issued by the United States Bankruptcy Court for the Southern District of New York ("Bankruptcy Court") in the liquidation proceeding of Bernard L. Madoff Investment Securities LLC ("BLMIS") under SIPA. The Appellants are claimants in the liquidation proceeding ("Claimants") who challenged in the Bankruptcy Court the Trustee's determination of their claims as it relates to the calculation of their "net equity," that is, under SIPA, what they are owed. The Trustee determined that customers' net equity was the amount deposited by them with the broker less any withdrawals by them. The Trustee did not, as sought by the Claimants, base their net equity on amounts shown on the Claimants' last account statement because the account statements were fictitious and reflected fake securities positions "paid for" out of fake profits in amounts that were fabricated by the principal of the firm, Bernard Madoff ("Madoff"). In a memorandum decision, upon a motion by the Trustee (JA vol. I, p. A-270), the Bankruptcy Court affirmed the Trustee's determinations, and issued an Order thereon. In re Bernard L. Madoff Inv. Securities LLC, 424 B. R. 122 (Bankr. S.D.N.Y. 2010) (JA vol. III, pp. A-547--599, A-600 ("Net Equity Order")).[2] By Order dated March 8, 2010, the Bankruptcy Court certified its Net

[2] References herein to pages of the joint appendix ("JA") shall be to the volume number of the joint appendix, followed by the page number.

Equity Order for immediate appeal to this Court of Appeals under 28 U.S.C. section 158(d)(2). See JA vol. I, p. A-190 (Doc. No. 2022). On June 16, 2010, the Court authorized this direct appeal.

STATEMENT OF FACTS

The Bankruptcy Court's findings of fact (see 424 B. R. at 126-132, and JA vol. III, pp. A-554—563) are amply supported by the record in this case. It should be noted, however, that while many Claimants agree that the basic facts are undisputed, some now argue that the Bankruptcy Court failed to afford them an opportunity to conduct discovery. For example, Claimant Elins asserts that the Bankruptcy Court should have disregarded "the conclusory and inadmissible matters contained in the Looby Declaration." Elins and Malibu Trading and Investing, L.P. Brief at 6. Mr. Elins does not identify which matters in the declaration in question were "conclusory and inadmissible" nor did he identify for the lower Court the facts allegedly in dispute or proffer any evidence below suggesting that a question of fact existed. It is well established in the Second Circuit that the Court generally will not consider an issue raised for the first time on appeal. See, e.g., In re Nortel Networks Corp. Sec. Litig., 539 F.3d 129, 132 (2d Cir. 2008). In particular, "[t]he law in this Circuit is clear that where a party has shifted his position on appeal and advances arguments available but not pressed below...waiver will bar raising the issue on appeal." Wal-Mart Stores,

Inc. v. Visa U.S.A., Inc., 396 F.3d 96, 124 n. 29 (2d Cir.), cert. den. sub nom., Leonardo's Pizza by the Slice, Inc. v. Wal-Mart Stores, Inc., 544 U.S. 1044 (2005) (internal quotation marks and citations omitted). While the waiver doctrine is prudential, not jurisdictional, and the court retains discretion to consider new arguments on appeal to avoid a manifest injustice, the court will not do so where "those arguments were available to the [parties] below and they proffer no reason for their failure to raise the arguments below." See Nortel Networks, 539 F.3d at 133. The Second Circuit is particularly reluctant to consider factual issues raised for the first time on appeal, and rarely does so. See, e.g., Paese v. Hartford Life & Accident Ins. Co., 449 F.3d 435, 446 (2d Cir. 2006); Baker v. Dorfman, 239 F.3d 415, 420-21 (2d Cir. 2000). It should not do so here.

A. The Placement of BLMIS In Liquidation

On December 15, 2008, upon an application by SIPC, BLMIS, a securities broker-dealer and member of SIPC, was placed in SIPA liquidation by Order of the United States District Court for the Southern District of New York ("District Court"). The District Court appointed Irving H. Picard, Esquire, as trustee for the firm and consistent with SIPA section 78eee(b)(4), removed the liquidation proceeding to the Bankruptcy Court. See JA vol. I, p. A-21 (Doc. No. 1), and JA vol. III, p. A-553.

Procedures for the filing of claims with the Trustee were approved by the

Bankruptcy Court. See JA vol. I, p. A-22 (Doc. No. 12), and JA vol. III, pp. A-553--554. Consistent with SIPA, the procedures provided, among other things, for the submission of claims to the Trustee, a determination by the Trustee of the claims, satisfaction by the Trustee of allowed claims, and an opportunity by any claimant who disagreed with the determination of his claim to seek Bankruptcy Court review. The Trustee processed all claims on the basis that what customer claimants were owed, that is, their "net equity" as defined under SIPA, was the net amount deposited by them with the brokerage.[3] The Trustee determined the claims to be ones for "securities" instead of "cash," making each customer eligible for up to $500,000 of SIPC protection, instead of $100,000 which is the limit of protection for cash claims. See SIPA §78fff-3(a). Thus, in addition to having his claim satisfied out of "customer property," the customer could receive up to $500,000 from funds advanced to the Trustee by SIPC.

The Claimants filed claims with the Trustee. See JA vol. III, pp. A-563—564. The Claimants disagreed with the Trustee's determination of their claims, arguing that what they were owed were the securities positions or the cash value thereof, shown on the last account statement issued to them by BLMIS. The account statements were fictitious, as were the securities positions and profits

[3] "Net equity" is defined at SIPA section 78lll(11) and essentially is the difference between what the broker owes the customer and what the customer owes the broker.

appearing on them, having been invented by Bernard Madoff to yield "returns" pre-determined by him.

B. The Fraud

i. The Claimant-Investors:

The record reflects that in opening a "customer" account at BLMIS, investors generally signed at least three documents. These documents were entitled: 1) Customer Agreement ("Agreement"); 2) Trading Authorization Limited to Purchases and Sales of Securities and Options ("Trading Authorization"); and 3) Option Agreement. JA vol. I, pp. A-528--533. See JA vol. I, pp. A-539--540 and A-543--545, 547, and 549--550.

The Customer Agreement specified that in order to induce the broker to open or maintain an account for it, the claimant agreed to abide by the terms of the Agreement. Among other things, the Agreement also provided that BLMIS was the claimant's agent unless the claimant was otherwise notified in writing before the settlement date of a trade. (JA vol. I, pp. A-531, A-532).

Under the Trading Authorization, the claimant conferred discretionary authority upon Madoff to buy and sell securities for the claimant's account. (JA vol. I, p. A-528).

The Option Agreement contained an acknowledgment by the investor of the risks of options trading and an authorization to the broker to take any necessary

steps in the event the claimant failed to satisfy its transaction obligations on a timely basis. (JA vol. I, p. A-529, A-549).

Having opened accounts with BLMIS, the claimants typically received periodic account statements issued on BLMIS letterhead, as well as a "Year-End Summary Report" issued by an accounting firm. The statements and reports reflected numerous securities positions bought and sold by BLMIS for the claimant and the dates and prices of the trades. The securities included stocks, U. S. Treasury Bills, and shares of a Fidelity fund. See, e.g., JA vol. I, pp. A-552—558.

The claimants made deposits to, and withdrawals from, their accounts. In certain cases, because of the sizeable "appreciation" of the accounts, the total amounts withdrawn by the claimants exceeded many times over the total amounts they deposited. In actuality, no real trading took place in the accounts. As in the classic Ponzi scheme, Madoff used new investors' money to pay previous investors "profits" in order to perpetuate the scam. Any "profits" in the account were phantom profits – the product of Madoff's imagination.

ii. The BLMIS Structure

The Madoff fraud was carried out mainly through BLMIS's Investment Advisory ("IA") business which acted both as an investment advisor to its clients and a custodian of their "securities." Looby Dec. ¶32 (JA vol. I, p. A-507). Customers were of two types at BLMIS: those whose funds reportedly were placed

into simulated baskets of stocks that were hedged by fake options positions under a "split strike conversion strategy" ("split strike") and those for whom supposed trades were customized. Id. ¶¶38, 48, 50 (JA vol. I, pp. A-508 – 510). As of approximately November 30, 2008, Frank DiPascali, Jr. ("DiPascali"), Madoff's chief lieutenant, administered 4,659 active accounts which constituted the bulk of the accounts and primarily were of the split strike kind. Id. ¶42 (JA vol. I, p. A-509). The non-split strike accounts numbered fewer than 245 and were administered by other BLMIS employees. The latter investors largely were long time favored customers of BLMIS or Madoff insiders. Id. ¶75 (JA vol. I, p. A-514). No securities actually were purchased by BLMIS for the split strike customers and virtually none were purchased for the non-split strike investors. Id. ¶¶51, 56, 79, 94, 95 (JA vol. I, pp. A-510, 511, 515, 518). While fake investments reportedly amounted to a net sum of approximately $64.8 billion by early December 2008, in reality, the total amount of net funds deposited by customers with the broker was less than $20 billion. Id. ¶¶22, 24 (JA vol. I, p. 505).

iii. The Account Statements

Even though no trades generally were placed, BLMIS issued customer account statements showing "trades" for customers over a period of months or years. See JA vol. I, pp. A-366--367. The fictitious account statements were

generated by means of a computer system that differed markedly from the computer system used in the other facets of the BLMIS business, namely, its market making and proprietary trading units. Looby Dec. ¶¶9, 15, 16, 40 (JA vol. I, pp. A-503, 504, 508). Unlike the latter business units which had live computer systems that interfaced with other trading platforms, third party feeds, and data sources, the IA computer system was a closed system -- separate and distinct from the other computer systems and not connected, interfaced or reconciled with any other live system. Id. ¶¶28, 29, 30 (JA vol. I, p. 506). The system made possible the mass production of fictitious customer statements. The system contained software that could be used to enter fictitious "trades" at any desired price or on any desired date that could then be allocated to the various customer accounts residing within the database. Inputting the data did not cause a trade to be made. It merely created a record that could be printed onto a fake account statement or fake trade confirmation. Id. ¶¶41, 44, 46 (JA vol. I, pp. A-508--509).

BLMIS did not provide customers with electronic real-time online access to their accounts which by the year 2000 would have been customary in the industry. For obvious reasons, it continued to rely on outmoded technology that produced paper trade confirmations, transmitted by mail. Id. ¶37 (JA vol. I, p. A-508).

iv. The "Trades"

With respect to the split strike investors, the "trades" in any basket of

securities reflected backdated prices that were selected in order to yield returns invented by Madoff. Once a basket "trade" had been identified as yielding a desired fake return, it would be keyed manually into the computer system. The basket "trade" would then be replicated proportionately among split strike customer accounts. Id. ¶¶60, 63, 64 (JA vol. I, pp. A-512--513). Because of the backdating, the split strike accounts yielded consistent annual returns generally between 10% and 17%, and largely outperformed the movement of the S&P 100 Index from which the "stocks" were chosen. Id. ¶¶62, 66 (JA vol. I, pp. A-512--513).

The prices at which "securities" were bought and sold and the purported returns were fake not only because of the backdating, but for other reasons as well. For example, one money market fund in which customers allegedly invested was not available for investment from 2005 onwards. Id. ¶57 (JA vol. I, p. A-511). There was often an insufficient volume of options contracts actually being traded to hedge properly the fake equities positions. Id. ¶97 (JA vol. I, p. A-518). The volume of outstanding fake positions in securities at times far exceeded the actual volume of shares traded on the market and necessarily would have impacted market price. Id. ¶¶100-104 (JA vol. I, pp. A-519--520). In many instances, prices appearing on the account statements were outside of the daily range of prices for the securities in question. Id. ¶106 (JA vol. I, p. A-520). It also is

noteworthy that there was not enough cash to pay for "purchased" securities positions. For example, in 2002, the "purchase" of $17.9 billion of securities was reported when only $240 million of customer funds was actually held by the brokerage. Id. ¶¶98, 99 (JA vol. I, p. A-519).

The fake "trading" at backdated prices was admitted to by DiPascali who was a chief Madoff confederate in carrying out the crime and who pled guilty to the ten criminal counts against him. See JA vol. I, p. A-384. As stated in the criminal information against him:

> 10. Madoff, [DiPascali] and other co-conspirators knew that the Split Strike strategy was a fiction in that the Split Strike Clients' funds were not invested in the securities recorded on those clients' account statements. The reported performance of the Split Strike strategy was fabricated by Madoff, [DiPascali] and other co-conspirators through a process in which transactions were "executed" only on paper, based on historically reported prices of securities, for the purpose of producing and sending to Split Strike Clients documents that falsely made it appear that BLMIS had achieved the promised "returns" of approximately 10 to 17 percent per year.
>
> 11. On a regular basis, Madoff provided guidance to [DiPascali], and, through [DiPascali], to other co-conspirators, about the gains or losses that Madoff wanted to be reflected in the account statements of the Split Strike Clients. Based on that guidance, [DiPascali] and other co-conspirators prepared model baskets of S&P 100 stocks based on historical market prices and tracked how those hypothetical baskets would have performed in the actual marketplace to determine whether and when to "enter the market." Whenever Madoff informed [DiPascali] that he had decided to "enter the market," [DiPascali] and other co-conspirators caused BLMIS computer

operators to enter the data related to the chosen basket of securities into the computer that maintained the books and records of the [investment advisory services] business. Madoff, [DiPascali], and other co-conspirators used computer programs to allocate multiples of the chosen basket to Split Strike Clients on a pro rata basis, based on each such client's purported account balance. When Madoff made a final decision to "enter the market," [DiPascali] and other co-conspirators would cause the computer to produce tens of thousands of false documents that purported to confirm the purchases of securities that in fact had not been purchased.

12. The purported trades by which BLMIS supposedly "entered the market" were sometimes priced using data from market activity that occurred one or more days prior to the date on which the decision to "enter the market" was finalized. Because none of the "trades" actually occurred, Madoff, [DiPascali], and other co-conspirators relied on historical price and trading volume data obtained from published sources of market information. With the benefit of hindsight, Madoff and [DiPascali] chose the prices at which securities purportedly were purchased in light of Madoff's objectives. * * *

13. A similar process to that described in paragraphs 11 and 12, above, was used in "exiting the market" by "selling out" of the purported stock and option positions and "buying" United States Treasury bills and shares in a money market fund with the "proceeds" of those purported sales. With the benefit of hindsight, Madoff and [DiPascali] evaluated whether and when to "sell out" of the securities positions that previously had been reported to Split Strike Clients. After such decisions were made, [DiPascali] and other co-conspirators caused BLMIS computer operators to input data that generated tens of thousands of false confirmations of the purported transactions, which were subsequently printed out and sent to Split Strike Clients through the United States mails. * * *

Information filed on August 11, 2009 at 6-8, United States v. Frank DiPascali, Jr., No. 1:09-cr-00764-RJS-1 (S.D.N.Y.).[4] See also JA vol. I, p. A-366 ("On a regular basis I used hindsight to file historical prices on stocks then I used those prices to post purchase o[r] sales to customer accounts as if they had been executed in realtime. On a regular basis I added fictitious trade data to account statements of certain clients to reflect the specific rate of earn return that Bernie Madoff had directed for that client.").

So that federal reporting requirements could be evaded, baskets regularly were "sold" and securities positions reduced to "cash." Looby Dec. ¶¶53, 55 (JA vol. I, pp. A-510--511). The fake cash, including fake profits, would then be reinvested in new fake securities positions, with fake profits being compounded with each new "purchase" and "sale." Id. ¶¶69-70 (JA vol. I, p. A-513.) In the midst of this fraudulent activity, therefore, the only real events that occurred in each account were the customers' deposits of funds into accounts and their withdrawals. Because no trades were real and no actual profits generated, when monies were withdrawn, the money did not come from a customer's account. It came from other customers. Id. ¶¶51, 71 (JA vol. I, pp. A-510, 513--514).

The trading was equally fake and back-dated with respect to the non-split strike investors. The main differences were that the selected backdated "trades"

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[4] See www.justice.gov/usao/nys/madoff/20090811dipascaliinformationsigned.pdf

were one-off "trades" instead of baskets of "trades." Moreover, instead of returns of 10% to 17%, the yields often exceeded 100%. Id. ¶¶74, 76-79 (JA vol. I, pp. A-514--515).

Those customers who withdrew their monies while the firm did business necessarily did "better" than others. Thus, in the scheme, some investors recovered their principal and received millions of dollars in false profits and they continue to claim millions of dollars of false profits in the liquidation proceeding. Other customers, whose monies were used to pay others, have yet to recapture the amounts they deposited with the broker.

SUMMARY OF ARGUMENT

It is a fact beyond peradventure that Bernard Madoff committed a ruthless crime that harmed his victims, some more egregiously than others. On this there can be no disagreement and for the innocent among them, there can be only much sympathy. But in robbing Peter to pay Paul, it also is undeniable that Madoff, by design or happenstance, favored some investors to the detriment of others. While all are victims, those investors who withdrew their deposits and received "profits" consisting of other investors' money clearly are the favored ones. They rank first among equals. Far behind are the investors who had the misfortune not to withdraw their funds. They are the victims left holding the bag.

By means of its decision in this appeal, this Court can either perpetuate the

crime or undo it in order to place or begin to place all of the investors on an equal footing. The choice is clear under SIPA and the law of this Circuit. What the customer is owed under SIPA is his "net equity," that is, the net amount that he deposited into the scheme, and not the fake profits that Madoff invented.

ARGUMENT

I. OVERVIEW OF SIPA

Although some of the Claimants attempt to portray this appeal merely as a dispute over SIPC protection or "insurance" as they incorrectly describe it,[5] the outcome will have much more severe consequences beyond the SIPC protection, for those who suffered the greatest harm, that is, the customers whose funds were used to pay other investors and who have yet to get back their principal. In that regard, an understanding of two aspects of SIPA is particularly important. These are, one, the burden of proof in a SIPA case, and two, how customer claims are satisfied under SIPA. Each is discussed below.

A. The Customer's Burden of Proof

In order to be protected under SIPA, a claimant must be a "customer," as defined in SIPA section 78lll(2). Because "customer" status is a preferred status that gives customers priority over other creditors in the distribution of certain

[5] The SIPA protection is a form of statutory protection and not "insurance." See SEC v. Albert & Maguire Sec. Co., 560 F.2d 569, 572 n. 2 (3d Cir. 1977); In re Stratton Oakmont, Inc., 2003 WL 22698876, at *5 (S.D.N.Y. Nov. 14, 2003).

assets, a claimant seeking "customer" protection under SIPA has the burden of proving both his status as a "customer" and what he is owed. See SIPC v. I.E.S. Mgmt. Group, 612 F.Supp. 1172, 1177 (D.N.J. 1985), aff'd w/o opinion, 791 F.2d 921 (3d Cir. 1986) ("customers" under SIPA receive preferential treatment by being satisfied ahead of general creditors). See also In re Adler Coleman Clearing Corp., 198 B.R. 70, 71 (Bankr. S.D.N.Y. 1996) ("person whose claim against the debtor qualifies as a 'customer claim' is entitled to preferential treatment"); In re Hanover Square Sec., 55 B.R. 235, 237 (Bankr. S.D.N.Y. 1985) ("[a]ffording customer status confers preferential treatment"); In re Government Sec. Corp., 90 B.R. 539, 540 (Bankr. S.D. Fla. 1988) ("customers" under SIPA have "preferred status").

Provisions of SIPA make clear the claimant's burden by requiring that a debtor's obligations to its customers be "ascertainable from the books and records of the debtor" or "otherwise established to *the satisfaction of the trustee.*" SIPA §78fff-2(b) (emphasis added). See In re Brentwood Sec., Inc., 925 F.2d 325, 328 (9th Cir. 1991) (claimants have burden of proving that they are customers by establishing that they entrusted cash or securities to the broker); In re Adler Coleman Clearing Corp., 204 B.R. 111, 115 (Bankr. S.D.N.Y. 1997); Schultz v. Omni Mutual, Inc., [1993-94] Fed. Sec. L. Rep. (CCH) ¶98,095 at p. 98,763 (S.D.N.Y. 1993). Moreover, that an investor is a "customer" as to one transaction

does not make him a "customer" for all time as to all transactions or amounts claimed. Customer status "in the air" is insufficient to confer such status as to all amounts sought by a claimant against a broker if outside the ambit of SIPA. See SEC v. F. O. Baroff Co., 497 F.2d 280, 282 n.2 (2d Cir. 1974); In re Stalvey & Associates, Inc., 750 F.2d 464, 471 (5th Cir. 1985).[6]

B. The Distribution of Funds Under SIPA

In a SIPA case, those who can demonstrate that they are "customers" are favored over non-customers in two ways:

One, they share in "customer property" to the exclusion of all others. "Customer property" generally includes all cash and securities held by or for a broker's account from or for its customers' securities accounts. SIPA §78lll(4). It is the securities and cash held by the broker for customers on the "filing date" and such customer property as a trustee is able to recover for the benefit of customers.[7]

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[6] To the extent that before the commencement of the liquidation proceeding, the claimant recovered the amount of his net deposit and now seeks fake profit, he is not a "customer" under SIPA notwithstanding that he was a customer at one time.

[7] A customer's net equity is measured as of the "filing date." SIPA §78lll(11). See SEC v. Aberdeen Securities Co., 480 F.2d 1121, 1123-1124 (3d Cir.), cert. den. sub nom., Seligsohn v. SEC, 414 U. S. 1111 (1973) (customer account must be valued as of filing date in order to determine net amount owed to customer or customer's "net equity"). If, as with respect to BLMIS, a proceeding was pending against the debtor in which a receiver was appointed, the filing date relates back to the date on which that proceeding began. See SIPA §78lll(7)(B), and Order Appointing Receiver, SEC v. Bernard L. Madoff Investment Securities LLC, No.

Two, to the extent of a shortfall in customer property, customer claims may be satisfied out of funds advanced to the SIPA trustee by SIPC.

C. The Distribution of Customer Property

SIPA section 78fff-2(c)(1) establishes the order of distribution of customer property. Only the second and third priorities of distribution under section 78fff-2(c)(1) are relevant here. They are:

- As a second priority, customer property is distributed ratably among customers based on their filing date net equities. §78fff-2(c)(1)(B).
- As a third priority, customer property is distributed to SIPC as subrogee. §78fff-2(c)(1)(C).

If a customer has been fully satisfied, SIPC is subrogated to the customer's share of customer property to the extent of its advance for that customer. §78fff-3(a). The amount of any SIPC advance is based on the difference between the customer's net equity and his share of customer property, subject to the limits of protection.

The distribution process is summarized in the legislative history of SIPA as follows:

> [Section §78fff-2(c)(1)], the operative provision with respect to customer property, provides that each customer will be allocated a ratable share of customer property based upon his net equity. This allocation is fundamental to the process of

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1:08-cv-10791-LLS (S.D.N.Y. Dec. 12, 2008).

> determining the extent to which SIPC protection will be available to a customer, because SIPC advances are applied to the difference between a customer's ratable share of customer property and his net equity claim.... [Emphasis added].

Hearings on H. R. 8331 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 95th Cong. 32 (1978). It bears emphasis that the SIPC advance does not reduce the customer's net equity or, therefore, his claim against customer property. As stated in H. R. Rep. No. 95-746, at 29 (1977) (JA vol. I, pp. A-597, 625):

> ...customer property would be allocated ratably among customers in satisfaction of their respective net equity claims. To the extent that a customer's net equity claim is unsatisfied by customer property, the customer is entitled to an advance of funds from SIPC up to the amount permitted by the bill.

See S. Rep. No. 95-763, at 13 (1978), reprinted in 1978 U.S.C.C.A.N. 764, 776. (JA Vol. III, p. A-336). See also In re Bell & Beckwith, 104 B.R. 852 (Bankr. N. D. Ohio 1989), aff'd, 937 F.2d 1104 (6th Cir. 1991).

The distribution scheme is illustrated below:

Scenario 1: An Illustration of A Distribution of Customer Property Followed By A SIPC Advance

Assume that a brokerage firm in SIPA liquidation has only two customers: Customer A and Customer B whose valid net equity claims for securities respectively are $500,000 and $3.5 million, for a total of $4 million. Assume also

that the trustee collects $2 million in customer property. The satisfaction of A and B's claims, based on a 50% distribution of customer property ($2 million ÷ $4 million), would be as follows:

Customer	Customer's Net Equity	Pro Rata Share Of Customer Property	SIPC Advance	Total Received by Customer	Amount Still Owed to Customer and/or SIPC
A	$500,000	$250,000	$250,000	$500,000	$0
B	$3.5 million	$1.75 million	$500,000	$2.25 million	$1.25 million
Totals:	$4 million	$2 million	$750,000	$2.75 million	(B+SIPC= $2 million)

Scenario 2: An Illustration of A Customer's Net Equity Satisfied From A SIPC Advance Followed By A Distribution of Customer Property

If a trustee were able to collect all customer property immediately and distribute it to customers before SIPC advanced any funds for customers, then SIPC would never share as subrogee in customer property under SIPA §78fff-2(c)(1)(C) because no customer property would remain for distribution to it. However, because, in reality, the collection of customer property takes time, SIPC may advance funds to a trustee for customers even when the amount of customer property is unknown. See SIPA §78fff-2(b)(1). Under SIPA, customers are not made to wait to have their claims satisfied while the trustee collects customer property, even if ultimately, there would have been enough customer property to

make customers whole without the use of SIPC funds. Once the customer is fully satisfied, SIPC is subrogated to the customer's claim against customer property. As illustrated below, whether or not customers are first satisfied with funds from SIPC, the result is the same.

In this hypothetical, assume the following: Customer A has a valid net equity claim for securities for $500,000 and Customer B has a valid net equity claim for securities for $3.5 million, for a total of $4 million, but there is no customer property immediately available for distribution. SIPC advances funds to the trustee so that the trustee can promptly begin to satisfy claims. As the trustee collects customer property, to the extent any customer has been fully satisfied due to the advance, SIPC stands in that customer's shoes as subrogee. The distribution is as follows:

Customer	Customer's Net Equity	SIPC Advance	*Pro Rata* Share of Customer Property	Total Received By Customer	Amount Still Owed to Customer and/or SIPC
A	$500,000	$500,000	$0	$500,000	$0
B	$3.5 million	$500,000	$1.75 million	$2.25 million	$1.25 million
SIPC as Subrogee			$250,000		$750,000
Totals:	$4 million		$2 million	$2.75 million	(B+SIPC = $2 million)

Whether the SIPC advance is made before or after customer property is distributed, the outcome is the same.

Scenario 3: An illustration of the impact of "net equity" on the distribution of customer property

As shown above, irrespective of the timing of the SIPC advance, the calculation of the customer's share of customer property does not change. Because net equity is calculated without reference to the SIPC advance, see In re Bell & Beckwith, 937 F.2d 1104, 1109-1110 (6th Cir. 1991), the amount of customer property received by one customer necessarily affects the amount received by the next. As a final illustration:

Assume that the brokerage is BLMIS and that while it is in business, Investor A deposits $2 million with the firm. Over time, the account "grows" to $4 million so that it includes the initial $2 million deposit and an additional $2 million of fake profit. Assume that A decides to withdraw $2 million from his account on the day that Investor B opens an account with $2 million. BLMIS does not have the money to pay A his withdrawal and therefore, gives B's money to A. BLMIS is placed in liquidation shortly after B opens his account and after he has received a fake statement showing fake securities positions in his account. Investors A and B both file claims for the amounts shown on their last account statements: A for the $2 million in securities that he believes is still in his account but actually have been

"paid for" with fake profit, and B for the $2 million in securities that actually represents the $2 million that he deposited with BLMIS.

Under the fictitious statement approach, assuming only two investors (A and B), each would have a net equity of $2 million for a combined net equity of $4 million. Under the Trustee's approach, the net equity of A is $0 and of B, is $2 million, for a total of $2 million. Assume the Trustee collects $1 million in customer property. Claims are satisfied as follows under each approach:

Trustee's Approach:

Customer	Customer's Net Equity	Pro Rata Share of Customer Property	SIPC Advance	Total Received by Customer	Amount Still Owed Customer
A	$0	$0	$0	$0	$0
B	$2 million	$1 million	$500,000	$1.5 million	$500,000
Totals:	$2 million	$1 million	$500,000	$1.5 million	$500,000

Fictitious Statement Approach:

Customer	Customer's Net Equity	Pro Rata Share of Customer Property	SIPC Advance	Total Received by Customer	Amount Still Owed to Customer
A	$2 million	$500,000	$500,000	$1 million	$1 million
B	$2 million	$500,000	$500,000	$1 million	$1 million
Totals:	$4 million	$1 million	$1 million	$2 million	$2 million

Under the fictitious statement approach, while the firm was still in business, A would have recaptured his initial deposit of $2 million by receiving B's money. In liquidation, A would receive 1) an additional $500,000 of customer property that otherwise would be distributed to B; and 2) $500,000 from SIPC. Thus, on his $2 million deposit, A would receive a total of $3 million.

Under the fictitious statement approach, B would have recovered nothing while the firm was in business. In liquidation, B would recover $500,000 of customer property and $500,000 from SIPC for a total of $1 million on his $2 million claim. $1 million would still be owed to him.

In contrast, under the Trustee's approach, A would recover nothing in the SIPA liquidation and B would receive all of the customer property plus the SIPC advance, for a total of $1.5 million. B, who is the only party who is out-of-pocket, would recover $500,000 more under the Trustee's approach than under the fictitious statement approach. Likewise, under the Trustee's approach, the fake profits already received by A would not continue to grow.[8]

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[8] To take the analysis one step further, under the Trustee's approach, A and B would be on equal footing if the trustee successfully avoided the $2 million payment to A. In that event, A would return $2 million to the trustee which would increase the size of the fund of customer property to $3 million. Assuming A had filed a claim in the liquidation proceeding, A and B would each have a valid claim of $2 million. The $3 million of customer property would be shared equally by them, with each receiving $1.5 million. Each also would receive a $500,000 advance of SIPC funds, making both A and B whole.

From this illustration, it is clear that every dollar received by A, who already has recaptured his initial investment and more, is one dollar less for B who has yet to recover his initial investment. Thus, even in liquidation, as he did while the firm was in business, A continues to receive B's money, to the detriment of B, under the fictitious statement approach. As the BLMIS Trustee already has collected more than $1.5 billion for customers, with a number of lawsuits pending in which he seeks to recover more than $15 billion for customers, the calculation of net equity will have a genuine impact on the amount of customer property received by each customer including those investors who already recovered their principal and received sizeable sums of money belonging to others.

II. THE BANKRUPTCY COURT PROPERLY HELD THAT THE TRUSTEE'S CALCULATION OF NET EQUITY IS IN ACCORD WITH APPLICABLE LAW

1. The Trustee's Calculus Is Consistent With the Law of This Circuit

A. New Times and Earlier Decisions

The decision of this Court of Appeals in In re New Times Securities Services, Inc., 371 F.3d 68 (2d Cir. 2004) ("New Times I"), is significant to the resolution of the case at hand in two respects: the nature of the customer claim and the calculation of the customer's net equity.

Customers with two kinds of claims were involved in New Times I. One group of customers received account statements indicating that the customers were

invested in real mutual funds. Although the trades had not actually been made, the account statements mirrored in all respects what would have happened had the transactions taken place. See In re New Times Securities Services, Inc., 371 F.3d 68, 74 (2d Cir. 2004). Unlike the BLMIS case, no price manipulation was involved. The other group consisted of customers who gave money to the broker to invest in mutual funds that ultimately never existed, and whose account statements showed fake securities positions, artificial interest and fake dividend reinvestments. Id. at 74. The position of SIPC and the trustee in the case was that the first group of customers had claims for securities while the second group, whose securities never existed, had claims for cash. Id. at 74-75, 83.[9]

In resolving the issue of what the customers with claims for fake securities

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[9] The trustee's and SIPC's position was consistent with law in the Sixth Circuit holding that claims for fake securities are claims for cash. See id. at 84, n. 19.

Certain Claimants erroneously argue that SIPC's position in New Times is inconsistent with its position in this case. See Brief for Appellants Peskin et al. at 55-61. They contend that in New Times, SIPC relied upon the claimant's expectations instead of transactional reality and, as such, SIPC should be judicially estopped from taking a contrary position here. SIPC's position in New Times and here are not only fully consistent but are the same. In New Times, SIPC contended that the Court should disregard fictitious amounts which is the same view that it advances in this case. See New Times I, 371 F.3d at 88. In order for judicial estoppel to apply, the party against whom it is invoked must have taken an inconsistent position in a prior proceeding which the court must have adopted in some fashion. See, e.g., Peralta v. Vasquez, 467 F.3d 98, 105 (2d Cir. 2006), cert. den. sub nom., Jones v. Peralta, 551 U.S. 1145 (2007). As there is no inconsistent position, judicial estoppel does not apply.

were owed, the Court applied a two-pronged analysis. First, in deciding whether the customers had claims for cash or securities, the Court held that because the customers had directed that their funds be invested in securities and because they received confirmations and account statements reflecting such purchases, the customers' reasonable expectation was that the broker was holding securities for them. Thus, the customers had claims for securities, making each of them eligible for up to $500,000, instead of $100,000, of SIPC protection. Id. at 86. That is the approach the BLMIS Trustee took here.

Second, while the customers' account statements were persuasive evidence of the customers' intent, the Court otherwise limited reliance on them. Customers' net equity was not calculated based upon what appeared on the account statements. Instead, net equity would consist of the amount of the customers' initial deposit less fake interest and fake dividend reinvestments received. The Court noted that "basing customer recoveries on 'fictitious amounts in the firm's books and records would allow customers to recover arbitrary amounts that necessarily have no relation to reality … [and] leaves the SIPC fund unacceptably exposed.'" Id., 371 F.3d at 88 (citing brief filed in the proceeding by the Securities and Exchange Commission ("SEC")). That is the reasoning the BLMIS Trustee applied here.

In reaching its decision, the Court took note of the decision in another SIPA case, Theodore H. Focht, Trustee v. Tessie C. Athens (In re Old Naples Securities,

Inc.), 311 B. R. 607 (M.D. Fla. 2002) ("Old Naples"). See New Times I at 88. In that case in which bonds were "sold" but never bought and other investors' money was used to pay previous investors, the District Court remarked as follows with respect to "net equity" and the claimants' assertion that fake interest should be allowed:

> Especially where the payments to claimants will be made out of the quasi-public SIPA fund, permitting claimants to recover not only their initial capital investment but also the phony "interest" payments they received and rolled into another transaction is illogical. No one disputes that the interest payments were not in fact interest at all, but were merely portions of other victims' capital investments. If the Court were to agree with the Athens claimants, the fund would likely end up paying out more money than was invested in Zimmerman's Ponzi scheme. This result is not consistent with the goals of SIPA, which does not purport to make all victimized investors whole but only to partially ameliorate the losses of certain classes of investors.

311 B. R. at 616-617.

It bears mention that in reaching this result, the Old Naples Court agreed with the analysis set forth in In re C. J. Wright & Co., 162 B. R. 597 (Bankr. M.D. Fla. 1993) ("C. J. Wright"). There, responding to the position of the claimants that they were entitled to the return of their principal as well as interest that they would have earned if the debtor actually had bought certificates of deposit ("CD") for them and the CDs had matured, the Bankruptcy Court stated:

> Claimants as customers have claims for cash and are entitled to receive their net equity from the fund of customer property as defined in SIPA. Customer property is "cash ... at any time received, acquired, or held by or for the account of debtor ... including property unlawfully converted." 15 U.S.C. §78lll(4). Claimants entrusted cash to debtor which debtor used to improperly issue the deposit account evidence of indebtedness. Because debtor misappropriated these funds, claimants have a claim for that which they entrusted to debtor as customer property: the principal amount that was to be invested. Debtor did not convert the interest promised because it was never earned. Debtor only misused claimants['] initial investment. Likewise, net equity as defined in SIPA does not contain any reference to providing interest on claims to customers. Thus the most that claimants are entitled to receive is the return of the principal invested.
>
> Claimants agree with the trustee that the amount each claimant is entitled to receive must be reduced by distributions to claimants.

162 B. R. at 609-610.

Thus, the position of this Court of Appeals in New Times I that in the context of a Ponzi scheme, the customer's net equity under SIPA is the net amount deposited by the customer with the broker was not novel or without precedent. The Court reaffirmed this view in a later decision in the New Times proceeding. In In re New Times Securities Services, Inc. (Stafford v. Giddens), 463 F.3d 125, 130 (2d Cir. 2006) ("New Times II"), the Court stated in referring to its decision in New Times I:

> The court declined to base the recovery on the rosy account statements telling customers how well the imaginary securities were doing, because treating the fictitious paper profits as within the ambit of the customers' "legitimate expectations" would lead to the absurdity of "duped" investors reaping windfalls as a result of fraudulent promises made on fake securities. [citation omitted].

B. New Times As Applied to This Case

Consistent with New Times I, the Trustee in this case deemed the customers to have claims for securities because the claimants received account statements indicating securities were in their accounts. However, following the precedent of New Times and other cases, the Trustee declined otherwise to give effect to the statements because although the names of the issuers of many of the securities were "real," the statements bore no relation to reality, the prices having been determined not by the securities markets but by Madoff, the fake "profits" having been pre-determined by him, at least one "security" not existing, insufficient funds having been tendered by the investors to purchase the number of shares in question, and the number of outstanding shares of an issue held by all of the investors in many instances outnumbering the actual number of shares available for trading on any given day. As the Bankruptcy Court correctly held, the Trustee's calculation of net equity is consistent with the law of this Circuit. See Net Equity Order, 424 B. R. at 139-140 (JA vol. III, pp. A-575—576).

2. The Trustee's Calculus Is Consistent With SIPA and Rules Thereunder[10]

A. SIPA Section 78fff-2(b)

The Trustee's net equity calculus also fully comports with the requirement under SIPA that a trustee satisfy customers' net equity claims "insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee." SIPA §78fff-2(b). "Books and records" of a debtor are more than just account statements. See, e.g., SEC Rule 17a-3, 17 C.F.R. §240.17a-3 (2010) (specifying no fewer than twenty-two categories of "books and records" to be made and kept current by the broker or dealer). See also 15 U.S.C. §78q. Furthermore, if the books and records are

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[10] Certain of the Claimants argue that the New York Uniform Commercial Code ("UCC"), instead of SIPA, governs what the Claimants are entitled to receive. See, e.g., Sterling Equities Brief at 10-12. The argument fails on at least two grounds. First, to the extent that state law is inconsistent with SIPA which is federal law, it is preempted under the Supremacy Clause of the United States Constitution. See U.S. Const., Art. VI, cl. 2; In re Bevill, Bresler & Schulman, Inc., 59 B.R. 353, 378 (D.N.J.), appeal dismissed, 802 F.2d 445 (3rd Cir. 1986) (holding that state law that is inconsistent with SIPA is preempted). Here, to the extent that any state law would provide a different form of relief for the customer than under SIPA, SIPA controls. Second, the Official Comment to the UCC itself, expressly citing SIPA as an example, provides that SIPA overrides the UCC if the entity's affairs are being administered in an insolvency proceeding. See U.C.C. [Rev.] § 8-503, Official Comment 1 (2009) ("applicable insolvency law governs how the various parties having claims against the firm are treated. For example, the distributional rules for stockbroker liquidation proceedings under the Bankruptcy Code and Securities Investor Protection Act ...."). See also Amer. Sur. Co. of N.Y. v. Sampsell, 327 U.S. 269, 272 (1946) ("[F]ederal bankruptcy law, not state law, governs the distribution of a bankrupt's assets to his creditors").

unreliable, the claimant still must prove the obligation "to the satisfaction of the trustee." In the BLMIS case, the books and records and other information showed that the trades were backdated and fake, that the profits were fake, that certain claimants withdrew more than they put into their accounts, and that "securities" "purchased" with fake sales proceeds in fact were never paid for by the customer. For the Trustee to ignore what the books and records showed and to satisfy net equity claims based solely upon fictitious account statements would violate SIPA §78fff-2(b).

B. SIPC Series 500 Rules

The Trustee's calculus is equally in accord with Rules adopted by SIPC. The SIPC Series 500 Rules, 17 C.F.R. §300.500 et seq. (2010) ("Series 500 Rules")[11] identify when a customer's claim is for securities and when it is for cash. In New Times I, the Court noted that the underlying premise of the Rules -- "that a customer's 'legitimate expectations,' based on written confirmations of transactions, ought to be protected," -- applied with respect to fake securities and fake profits, but that the Rules themselves did not. 371 F.3d at 86-87. As the Second Circuit observed and as apparent from their history, the Rules apply "when a transaction in real securities straddle[s] the filing date and do not govern

[11] SIPC's Rules are subject to approval by the SEC, after notice and an opportunity for hearing, and have the force and effect of law. SIPA §78ccc(e)(2). See In re Adler Coleman Clearing Corp., 195 B. R. 266, 275 (Bankr. S.D.N.Y. 1996).

transactions involving fictitious securities...." 371 F.3d at 87.

The need for the Series 500 Rules grew out of a few SIPA cases. The most recent of the cases was In re Bell & Beckwith (Murray v. McGraw), 821 F.2d 333 (6th Cir. 1987) ("Murray"). See 53 Fed. Reg. at 10368, n. 1 (Mar. 31, 1988). On February 4, 1983, the Murrays instructed their broker to sell certain stock. The sale was executed and a statement confirming the sale was issued to the Murrays. The statement showed a "trade date" of February 4, and a "settlement date" of February 11. The trade date is the date on which parties enter into a contract to buy or sell a security. The settlement date is the date on which the buyer pays for, and the seller delivers, the security. New York Institute of Finance, Introduction to Brokerage Operations Dept. Procedures (2d ed. 1988) at 229, 233. One day after the trade date, and before the settlement date, the brokerage in Murray failed. The Murrays argued that notwithstanding the sale, their claim was for securities. In the intervening period between the placement of the firm in SIPA liquidation and the filing of the Murrays' claim, the stock had become more valuable. Murray, 821 F.2d at 334-335. The Sixth Circuit held the Murrays' claim to be for cash. Id., 821 F.2d at 339-340.

The Rules grew out of the aforementioned circumstances, providing "nationwide uniformity and reasonable certainty" to whether claims under SIPA were for cash or securities. 53 Fed. Reg. 10368 (Mar. 31, 1988). However, the

Rules themselves make clear that they apply only to transactions made in the ordinary course and reflecting market reality. Rule 503(a) specifically precludes application of the Rules if application interferes with a SIPA trustee's ability to "avoid any securities transactions as fraudulent, preferential, or otherwise voidable under applicable law." 17 C.F.R. §300.503(a) (2010).

3. <u>The Trustee's Net Equity Calculus Furthers the SIPA Objective of Not Endorsing Violations of the Securities Laws</u>

A. <u>SIPA As Part of the Securities Laws</u>

Implicit in the two New Times decisions is the recognition that to give unquestioning effect to fictitious account statements is to rubber-stamp fraud and other bad acts of a broker. In that vein, courts consistently have recognized that SIPA and rules promulgated thereunder "manifest a design to deny protection to transactions tainted by fraud." Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.), 263 B.R. 406, 435 (S.D.N.Y. 2001) ("Ensminger"). See Arford v. Miller (In re Stratton Oakmont, Inc.), 239 B.R. 698, 701 (S.D.N.Y. 1999), aff'd, 210 F.3d 420 (2d Cir. 2000); SEC v. S.J. Salmon & Co., 375 F. Supp. 867, 870-71 (S.D.N.Y. 1974); In re Adler, Coleman Clearing Corp., 198 B.R. 70, 75 (Bankr. S.D.N.Y. 1996). Where a claimant experiences no actual market risk, and can claim entitlement to cash or securities only because of a broker's fraud, no "customer" relief under SIPA is available. See, e.g., supra, New Times I and II;

Ensminger, 263 B.R. at 435. One reason for this outcome is that SIPC's goal of customer protection must be carried out consistent with the securities laws since SIPA itself is a part of the securities laws.

Except as otherwise provided in SIPA, the provisions of the Securities Exchange Act of 1934, 15 U.S.C. §78a et seq. ("the 1934 Act"), apply as if SIPA were an amendment to, and a section of the 1934 Act. SIPA §78bbb. Moreover, as explicitly provided in SIPA, while a primary function of the statute is to provide some protection to investors, another central function is to reinforce the broker-dealer's financial responsibility requirements so that the securities laws are strengthened and not weakened.[12] Cf., SEC v. Packer, Wilbur & Co., 498 F.2d 978, 985 (2d Cir. 1974) (purpose of SIPA is to strengthen market. Goal is not served by reimbursing from public funds one whose fraudulent activities have weakened it). The fact that SIPA has more than one purpose and that those purposes supply the reason for the exclusion under SIPC Rule 503, discussed above, was summed up by the District Court in Ensminger, supra, 263 B.R. at 434-435, as follows:

> [The broker's] extensive fraud has overarching

[12] As one example, under SIPA §78kkk(g), Congress charged the SEC with compiling a list of unsafe and unsound industry practices and required it to report upon the steps being taken under existing law to eliminate such practices and to provide recommendations for additional legislation needed to eliminate them.

> significance and implications for the transactions that culminated in the Challenged Trades.... Contrary to Appellants' perceptions of these events, [the broker's] deeds cannot be ignored in assessing whether Appellants are entitled to enforce the Challenged Trades. While it is true that one of SIPA's primary objectives is to protect individual customers from financial hardship, the legislation also embodies parallel and complementary aims....
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> * * * *
>
> The SIPC 500 Rules, promulgated in 1988, ... reflect these ends. They safeguard securities customers' legitimate claims to cash and securities held by the debtor in their accounts prior to filing date, and also manifest a design to deny protection to transactions tainted by fraud.

If as the claimants seek, the Trustee is forced to rely upon the last fictitious account statement, they will give credence to the backdated trades and fake profits that were invented by Madoff and carried out by Madoff and BLMIS in flagrant violation of the securities laws. While a central goal of SIPA is protection of the individual customer, the protection cannot be administered at the expense of undermining the securities laws. The District Court's decision in the Ensminger case contains an extensive analysis in this regard, and therefore is discussed in detail below.

B. Ensminger

In an appeal from a decision of the Bankruptcy Court,[13] the District Court in Ensminger, discussed many of the grounds for refusing protection to an investor in the context of a SIPA case involving fraudulent activity of a broker and artificial profits created by the broker. Almost all of the grounds apply with equal force here. Some of the more salient ones are examined below.

In Ensminger, the District Court denied "customer" protection to claimants whose broker reported to them that it had sold at inflated, above-market prices, certain near worthless "house stocks" in their accounts. The house stocks, although of negligible value, were nonetheless actual securities issued by existing corporations. The broker then used the fictional sales proceeds from these "sales" to buy valuable "blue chip" securities for their accounts. See Ensminger, 263 B.R. at 421-22. In denying the claimants' claim for the "blue chip" securities, the Court explained, inter alia, that the "sales" of the "house stocks" were reported to claimants at prices far above those the claimants could have obtained had the stocks been sold in the open market, and that, had the sales actually occurred at those prices, claimants would not have had enough cash to buy the "blue chips" sought in the liquidation. See Ensminger, 263 B.R. at 430 ("[T]here was no real cash in the Claimants' accounts because the trades never settled and the proceeds

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[13] Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.), 247 B. R. 51 (Bankr. S.D.N.Y. 1999) ("Mishkin v. Ensminger")

yielded by the Challenged Sales of House Stock, even at the inflated prices manipulated by Hanover [the broker], were not enough to cover the cost of the Blue Chips"). The Court concluded that affording the claimants customer status under SIPA was impermissible, observing that it

> would demand that during the transfiguration of credit into cash, the manifest improprieties in the methods the Appellants' broker-agents employed, by which the supposed "cash" materialized into the customers accounts in the first place, be overlooked, while at the same time maintaining that the entire trade be blessed as strictly arms-length, good faith and innocent.

Ensminger, 263 B.R. at 434.

The position of the claimants is no different in the case at hand. By asserting that the Trustee should rely only upon the last account statements, they effectively demand that the Trustee ignore the improprieties and fabrications leading to the invention of the amounts that the claimants now claim. No matter how innocent the claimants may be, the Trustee cannot. The rationale of the District Court in Ensminger in voiding the challenged trades in that case and in rejecting, on several grounds, the claimants' assertions of innocence, apply here as well.

i. The Broker as the Claimant's Agent

In Ensminger, the District Court rejected the claimants' contention that they were entitled to "customer" status due to their lack of knowledge of the broker's

fraud. The Court found that, as beneficiaries of their broker/agent's fraud, they were chargeable with the broker's actions and intent. See Ensminger, 263 B.R. at 453-58.

As the District Court held, the broker is the agent for the customer, and the agent's knowledge is imputed to the principal – the customer. The customer, as principal, is responsible for the fraud of its broker-agent, and cannot reap benefit from the broker's fraudulent schemes. Ensminger, 263 B.R. at 453-454. This rule applies notwithstanding the absence of the claimant's knowledge of the fraud or lack of its own fraudulent intent. Id. at 453, citing Curtis, Collins & Holbrook v. United States, 262 U.S. 215, 222 (1923) ("The general rule is that a principal is charged with the knowledge of the agent acquired by the agent in the course of the principal's business"). If a principal chooses to rely upon a transaction entered into by his agent on his behalf, the agent's knowledge will be imputed to the principal. Ensminger, 263 B.R. at 454. The principal cannot, on the one hand, claim the fruits of the agent's bad acts while repudiating the acts, on the other. As stated in Ensminger, id. at 453, citing Harriss v. Tams, 258 N.Y. 229, 179 N.E. 476, 479 (1932), as follows:

> [T]his court has held that principals, who after offer to rescind, retain or demand the fruits of a contract obtained by unauthorized representations of an agent 'stand in the same position as if they had made the representation or authorized it to be made.' (citations

omitted)

See Cathay Pacific Airways, Ltd. v. Fly and See Travel, Inc., 3 F.Supp.2d 443, 445 (S.D.N.Y. 1998) ("Under New York agency law, the principal may not accept the fruits of the agent's fraud and then attempt to divorce himself from the agent by repudiating the agent and his knowledge."), cited in Ensminger, 263 B.R. at 454. See also Eitel v. Schmidlapp, 459 F.2d 609, 615 (4th Cir. 1972) ("[T]he principal cannot claim the fruits of the agent's acts and still repudiate what the agent knew"). The outcome is the same even if the agent has acted adversely to the principal. In re Maxwell Newspapers, Inc., 164 B.R. 858, 867 (Bankr. S.D.N.Y. 1994); In re Investors Funding Corp., 523 F.Supp. 533, 540-541 (S.D.N.Y. 1980); First Nat'l Bank of Cicero v. United States, 625 F.Supp. 926, 931-932 (N.D. Ill. 1986).

In the BLMIS case, each of the claimants signed a Customer Agreement expressly designating BLMIS as the claimant's agent, as well as a Trading Authorization, giving BLMIS unfettered discretion to trade securities for the claimant's account. Any acts, knowledge and intent of BLMIS as agent are imputed to each claimant as principal and to the extent that the claimants seek to benefit from their agent's fraud and price manipulation, they are chargeable with the agent's actions, knowledge, and intent.

ii. The Fraudulent Trades Are Unenforceable

In Ensminger, the District Court agreed with the lower Court that irrespective

of whether the trustee in that case could maintain a cause of action for damages against the claimants grounded on the broker's fraud, he "nonetheless is entitled to rescind the Challenged Trades as products of an authorized agent's fraud." 263 B. R. at 457. The Court sustained the Bankruptcy Court's finding that the challenged trades were unenforceable as illegal contracts under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5; New York's Martin Act, N. Y. Gen. Bus. L. §352(1) (McKinney 1996); and SIPA section 78jjj(c). As the trades were unenforceable, the claimants could not rely upon them. The trades in BLMIS are illegal contracts and therefore, equally unenforceable.

a. Section 10(b) of the 1934 Act, and Rule 10b-5

In pertinent part, section 10(b) of the 1934 Act makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe ...." In pertinent part, SEC Rule 10b-5 makes it unlawful for any person to engage in various acts of fraudulent or deceptive conduct.[14] As stated in Ernst & Ernst v. Hochfelder, 425 U. S. 185, 195

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[14] Under Rule 10b-5, it is unlawful for any person

"(a) To employ any device, scheme, or artifice to defraud,

(1976), reh'g den., 425 U.S. 986 (1976), "[t]he 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges...." The Court further remarked in that case:

> Use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.

Id., 425 U. S. at 199.

On behalf of the claimants and other investors, BLMIS pretended to enter into contracts to buy or sell securities that were at pre-determined and backdated, and

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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

17 C.F.R. §240.10b-5 (2010).

The elements of a 10(b) action include 1) a material misrepresentation or omission; 2) scienter; 3) a connection with the purchase or sale of a security; 4) reliance; 5) economic loss; and 6) a causal connection between the material misrepresentation and the loss. Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 341-342 (2005).

therefore, artificial, prices. In doing so, BLMIS engaged in a price manipulation that operated as a fraud or deceit upon the investors and others. Further, in making untrue statements of material fact by means of the fictitious account statements and confirming to investors the fake "trades" at pre-determined returns, BLMIS engaged in an artifice or act to defraud and deceive, all in violation of section 10(b) of the 1934 Act and SEC Rule 10b-5.[15]

b. The Martin Act[16]

In relevant part, section 352-c(1)(a) of the Martin Act provides that

> It shall be illegal and prohibited for any person, ... to use or employ any of the following acts or practices:
>
> (a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale;....

In order for the Martin Act to be violated, only proof of the qualifying act need be shown; reliance and scienter are not required. See State v. Sonifer Realty Corp., 212 A.D.2d 366, 622 N.Y.S.2d 516 (1995); New York v. Barysh, 95 Misc.2d 616, 620-621, 408 N.Y.S.2d 190, 193 (1978). The reach of the Martin Act is broad.

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[15] In its action against BLMIS and Madoff, the SEC alleged that both defendants violated Section 10(b) of the Exchange Act and SEC Rule 10b-5. Complaint at 9, SEC v. Bernard L. Madoff, et al., No. 08 Civ. 10791 (S.D.N.Y. Dec. 11, 2008) (Dkt. No. 1). See http://www.sec.gov/litigation/complaints/2008/comp-madoff121108.pdf.

[16] N. Y. Gen. Bus. Law §§352 - 353 (McKinney 1996)

People v. Federated Radio Corp., 244 N.Y. 33, 38-39, 154 N.E. 655, 657 (1926) (fraud "includes all deceitful practices contrary to the plain rules of common honesty.") The victim need not be a buyer or seller of securities; nor need there be privity between the victim and the wrongdoer. People v. Florentino, 116 Misc.2d 692, 701-704, 456 N.Y.S.2d 638, 645-647 (N. Y. Crim. Ct. 1982). Once fraudulent activity has taken place, there need not even be any sale of securities for liability to be incurred. People v. Electro Process, Inc., 284 A.D. 833, 132 N.Y.S.2d 531, 532 (4th Dep't 1954). Any misrepresentation and omission must be of a material fact. E. F. Hutton & Co. v. Penham, 547 F.Supp. 1286, 1297 (S.D.N.Y. 1982).

BLMIS's backdating of "trades," its creation of fake profits, and its issuance of fictitious confirmation statements showing pretended purchases and sales, are clear violations of section 352-c(1)(a) of the Martin Act and therefore, are illegal.

c. Unenforceability of Illegal Contracts

In concluding, like the Bankruptcy Court, that the challenged trades were unenforceable or voidable, the District Court in Ensminger relied upon at least two authorities:

One, the rule that under both federal and New York law, illegal contracts cannot be enforced. Kaiser Steel Corp. v. Mullins, 455 U.S. 72, 77 (1982) ("illegal promises will not be enforced in cases controlled by the federal law"); Hurd v.

Hodge, 334 U.S. 24, 34-35 (1948) (courts will not enforce private agreements that violate public policy as manifested in federal statutes); United States v. Bonanno Org. Crime Fam. of La Cosa Nostra, 879 F.2d 20, 28 (2d Cir. 1989) (under federal and state law, illegal agreements and those contrary to public policy are unenforceable and void). See Ensminger, 263 B. R. at 493, and United Paper Workers International Union, AFL-CIP v. Misco, 484 U.S. 29, 42 (1987) ("no court will lend its aid to one who founds a cause of action upon an … illegal act").

Two, with respect to the violations of the federal securities laws, section 29(b) of the 1934 Act, 15 U.S.C. §78cc(b) ("Section 29(b)"). That section provides:

> Validity of contracts
>
> (b) Contract provisions in violation of chapter
>
> Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract ... heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation.

The District Court agreed with the Bankruptcy Court that the defense that section 29(b) is directed only at direct violators with actual knowledge, and not innocent parties, was unavailable to claimants inasmuch as they sought, as principals, to benefit from their agent's violations. See Ensminger, supra, 263 B. R. at 493-495, and Mishkin v. Ensminger, supra, 247 B. R. at 126-127 (§29(b) is complementary to other remedies. Even if the section does not compel rescission of trades, §10(b) of the Exchange Act and SEC Rule 10b-5 do.)

In all respects, the same result should obtain here. The "trades" are void and unenforceable by the Claimants.[17]

4. The Trustee's Net Equity Calculus Furthers SIPA's Function As a Bankruptcy Statute

A. Avoidance Under Ensminger

Although SIPA is part of the federal securities laws, it also makes applicable to the liquidation, to the extent consistent with SIPA, all of the provisions of Title 11 that apply in a Chapter 7 case except for subchapters I and II of chapter 7. SIPA §78fff(b). For that reason, as mentioned above, a SIPA proceeding has been described as a bankruptcy proceeding with special customer protection measures superimposed upon it. SEC v. Aberdeen Sec. Co., 480 F.2d 1121, 1123 (3d Cir.),

[17] In Ensminger, the District Court also upheld the rescission of the trades based upon fraud and false representation. 263 B. R. at 486-492. Although not discussed here, those grounds apply with equal force.

cert. den. sub nom., Seligsohn v. SEC, 414 U. S. 1111 (1973).

The SIPA trustee has powers that are unique to the SIPA proceeding, as well as powers that are prescribed by the Bankruptcy Code. SIPA §78fff-1(a). Thus, when customer property is insufficient to satisfy customers, SIPA expressly gives to the trustee the authority and power to recover property transferred by the debtor which, except for the transfer, would have been customer property. For purposes of recovery, the transferred property is deemed property of the debtor and if the transfer was made to a customer, the customer is deemed to have been a creditor notwithstanding state law to the contrary. Once recovered, the property again becomes "customer property" to be shared by "customers." SIPA §78fff-2(c)(3). See In re Park South Sec., LLC, 326 B. R. 505, 512-513 (Bankr. S.D.N.Y. 2005).

As the District Court in Ensminger noted, the foregoing authority is critical to an important objective of both ordinary bankruptcy and SIPA liquidations, namely, maximizing recovery for ratable distribution to all customers. As the Court stated:

> ...[T]he underlying philosophy of the Bankruptcy Code and SIPA establishes certain equitable principles and priorities designed to maximize assets available for ratable distribution to all creditors similarly situated.... To this end, the rules seek to prevent unjust enrichment and to avoid placing some claims unfairly ahead of others by distinguishing transactions truly entered in good faith and for value from those somehow induced and tainted by preference, illegality or fraud....

Ensminger, 263 B. R. at 463. In Ensminger, the challenged trades were held

avoidable as fraudulent transfers under various provisions of the Bankruptcy Code and under New York Debtor and Creditor Law.

B. The Salmon Cases

The Ensminger Courts have not been the only ones to allow trades to be avoided under similar circumstances, as seen in two decisions issued in the S. J. Salmon & Co., Inc. ("Salmon") SIPA liquidation proceeding. At issue in those cases were trades that the trustee alleged were neither bona fide nor the result of arm's length transactions in the open market, but recorded only on the books and records of the brokerage in order to improve the position of certain preferred customers in the face of the imminent liquidation of the firm. The trustee sought to avoid the transactions as fraudulent and void under avoidance provisions of the former Bankruptcy Act and New York Debtor and Creditor Law. In ruling in favor of the trustee, the Court concluded that the "trades" were transfers made with actual intent to defraud creditors, a deliberate attempt to defraud SIPC under SIPA, and done "without fair consideration." The Court also noted that the true value of the trades was "not the prices quoted on that date, but rather the quotations published by dealers after debtor's cessation of business...," and that the "artificially high prices would vanish when [the broker] ceased acting as a market maker." SIPC v. S. J. Salmon, No. 72 Civ. 560, 1973 U. S. Dist. LEXIS 15606, at *19, *20 (S.D.N.Y. Aug. 8, 1973). Significantly, the Court also remarked:

> ...[I]t is argued that the trustee's position in seeking to reverse the February 2d transactions is contrary to the purpose of SIPA. There is no validity to this point of view. It is true that SIPA was intended to afford greater protection to customers than they enjoyed under § 60e of the Bankruptcy Act, essentially by providing a limited form of insurance for customer claims for cash and securities. But SIPA was not intended to make the fraudulent transfer provisions of the Bankruptcy Act inoperative as to stockbroker-debtors in SIPA proceedings. While SIPA was intended to protect customers there is nothing in its provisions to indicate that less preferred creditors are to be denied the protection of the provisions which bar a debtor from making fraudulent transfers at their expense.

Id. at *31. The Court reached the same conclusion with respect to similar transactions in a later decision. SIPC v. S. J. Salmon, Case No. 72 Civ. 560, slip op. (S.D.N.Y. Feb. 5, 1974). See Appendix hereto.

In the instant case, the Bankruptcy Court correctly concluded that the Trustee's calculation of net equity rather than the fictitious statement approach was consistent with his statutory avoidance powers. Net Equity Order, 424 B. R. at 135 (JA Vol III, p. A-568). The avoidance provisions under federal and state law further the bankruptcy goal of ratable sharing of assets by creditors. Unless fake trades are avoided, claimants who were advantaged by a broker's fraud, that is, investors who received withdrawals that actually consisted of other investors' money under the guise of investment profits -- including those innocent investors

who received large sums of other investors' money over and above the amounts that they put into the scheme -- will be allowed to benefit at the expense of other equally innocent investors. The fact that some innocent victims arbitrarily will fare far better than others and at the expense of others, is one more reason for the Trustee not to be held hostage to the fictitious statements. It must be mentioned that while the Trustee's net equity calculus is consistent with his avoidance powers in furthering the equal sharing of property, the instant matter is not an avoidance suit but simply an attempt to ascertain the correct calculation under SIPA of net equity in this case. To the extent the Claimants have defenses to any avoidance suit brought by the Trustee, those defenses should be asserted in that action and not here. See, e. g., Joint Brief for Appellants The Aspen Company, et al., at 46-57.

III. THE BANKRUPTCY COURT DECISION CORRECTLY RECOGNIZES THE SCOPE OF PROTECTION UNDER SIPA

Ultimately, the decision of the Bankruptcy Court is correct because it recognizes that there is no SIPA protection for claims that are based on damages and not the recovery of property deposited with the broker. When a brokerage fails, SIPA protects the custodial function, that is, the property that has been entrusted to the broker by or for the customer. See SEC v. Kenneth Bove & Co., 378 F.Supp. 697, 699 (S.D.N.Y. 1974); SIPC v. Stratton Oakmont, Inc., 229 B.R. 273, 279 (Bankr. S.D.N.Y.), aff'd sub nom., Arford v. Miller, 239 B. R. 698

(S.D.N.Y. 1999), aff'd, 210 F.3d 420 (2d Cir. 2000) ("well established that SIPA protects customers ... who have entrusted to ... broker-dealers cash or securities in the ordinary course of business for the purpose of trading and investing"); In re Adler Coleman Clearing Corp., 204 B.R. 111, 114, 115 (Bankr. S.D.N.Y. 1997); SEC v. First Sec. of Chicago, 507 F.2d 417, 420 (7th Cir. 1974); In re Carolina First Sec. Group, Inc., 173 B. R. 884, 886 (Bankr. M.D.N.C. 1994) (no "customer" status as to property not entrusted to brokerage). See National Union Fire Ins. Co. v. Camp (In re Government Sec. Corp.), 972 F.2d 328, 331 (11th Cir. 1992), cert. den., 507 U. S. 952 (1993) (purpose of SIPA is "to return to customers of brokerage firms their property or money"); and SEC v. S. J. Salmon & Co., 375 F.Supp. 867, 871 (S.D.N.Y. 1974) (SIPA was designed to facilitate return of property to customers of insolvent firm or to replace such property when lost or misappropriated). The loss must be "occasioned by a broker's liquidation." SIPC v. Stratton Oakmont, Inc., supra, 229 B.R. 273, 279. See In re Stratton Oakmont, Inc. (Miller v. DeQuine), 42 Bank. Ct. Dec. (LRP) 48, at 220 (S.D.N.Y. 2003) (SIPA's main purpose to reverse losses resulting from broker's insolvency); In re Oberweis Sec., Inc., 135 B.R. 842, 846 (Bankr. N. D. Ill. 1991) (damage that would have occurred even if debtor not insolvent is not a direct result from insolvency and not protected under SIPA). See also In re Stalvey & Assoc., Inc., 750 F.2d 464, 473 (5th Cir. 1985) (SIPA only an "interim step" not providing

complete protection from losses incurred by firm failure); and Redington v. Touche Ross & Co., 592 F.2d 617, 624 (2d Cir. 1978), rev'd on other grounds, 442 U. S. 560 (1979).

In the final analysis, to the extent that the Claimants in this case have been harmed by the Debtor by more than the net amounts deposited by them, their claims are for damages which are general creditor, and not customer, claims. This is the true nature of their claims, but as to such losses, investors are not protected by SIPA. As stated by the Ninth Circuit in In re Brentwood Sec., Inc., 925 F.2d 325, 330 (9th Cir. 1991):

> Every market has its dreamers and its crooks. Occasionally, they are one and the same. The SIPA protects investors when a broker holding their assets becomes insolvent. It does not comprehensively protect investors from the risk that some deals will go bad or that some securities issuers will behave dishonestly.

Accord, SIPC v. Associated Underwriters, Inc., 423 F.Supp. 168, 171 (D. Utah 1975) ("SIPC is not an insurer, nor does it guarantee that customers will recover their investments which may have diminished as a result of, among other things, market fluctuations or broker-dealer fraud"); In re Klein, Maus & Shire, Inc., 301 B.R. 408, 421 (Bankr. S.D.N.Y. 2003) (claims for damages do not involve the return of customer property entrusted to broker and are not "customer" claims. Claims for damages resulting from misrepresentation, fraud or breach of contract

are not protected and are general creditor claims); In re MV Sec., Inc., 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985) (no SIPA protection for innocent investor against broker's fraud); SEC v. Howard Lawrence & Co., 1 Bankr. Ct. Dec. (CRR) 577, 579 (Bankr. S.D.N.Y. 1975) (no SIPA protection for claims based on fraud or breach of contract); In re Oberweis Sec., Inc., 135 B.R. 842, 846 (Bankr. N.D. Ill. 1991) (claim for damages resulting from broker's failure to invest funds as instructed are basis only for general creditor claim); In re Bell & Beckwith, 124 B.R. 35, 36 (Bankr. N.D. Ohio 1990) (no protection for claims based on broker's fraudulent conduct).

In the final analysis, the Trustee's calculation of net equity achieves the greatest return for the greatest number of victims of BLMIS's fraud. The fact that to some, the approach may seem inequitable is not the deciding factor. As this Court of Appeals stated in SEC v. Packer, Wilbur & Co., supra, 498 F.2d at 983:

> However, arguments based solely on the equities are not, standing alone, persuasive. If equity were the criterion, most customers and creditors of Packer Wilbur, the bankrupt, would be entitled to reimbursement for their losses. Experience, on the other hand, counsels that they will have to settle for much less. SIPA was not designed to provide full protection to all victims of a brokerage collapse. Its purpose was to extend relief to certain classes of customers.

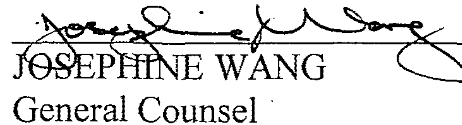
Accord, SIPC v. Morgan Kennedy & Co., 533 F.2d 1314, 1317, n. 4 (2d Cir.

1976), cert. den. sub nom., Trustee of Reading Works, Inc. v. SIPC, 426 U.S. 936 (1976).

CONCLUSION

For all of the aforementioned reasons, the Net Equity Order of the Bankruptcy Court should be affirmed in all respects.

Respectfully submitted,



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Date: September 20, 2010
Washington, D.C.

APPENDIX

EXHIBIT A

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

---x

SECURITIES AND EXCHANGE COMMISSION, Plaintiff,	:	72 Civ. 560
SECURITIES INVESTOR PROTECTION CORPORATION, Applicant,	:	
-against-	:	DECISION #2 ON TRUSTE MOTION FOR SUMMARY JUDGMENT AVOIDING CERTAIN TRANSACTIONS WHICH OCCURRED FEBRUARY 2D, 1972.
S. J. SALMON & CO., INC., Defendant.	:	

---x

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WILLIAM D. MORAN, ESQ.
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Opposed to the Motion

See list appended.

ASA S. HERZOG, REFEREE IN BANKRUPTCY:

The trustee filed an application, dated June 5, 1973, setting forth in paragraph 35 thereof his objection to certain alleged customer claims arising from specified

transactions which purported to take place on February 2, 1972 regarding certain securities which the trustee has labelled the "Salmon Nine".[1] The trustee's objections relate to 27 sales (involving 13 accounts) allegedly made on February 2, 1972 by the respondent customers of the debtor of shares of one or more of the "Salmon Nine" to the debtor's trading account.[2]

The trustee's position is that the aforesaid alleged sales and cancellations of prior purchases recorded on the books and records of debtor on February 2d were not *bona fide* transactions, could not have been effected in arm's length transactions in the open market, were inconsistent with and contrary to any effort to improve debtor's net capital position, and were recorded solely for the purpose of improving the cash claims of selected customers of debtor, the principals of debtor knowing that (i) a liquidation of debtor was imminent (ii) cash claims in such a liquidation would be paid with

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1 The "Salmon Nine" consisted of the common stock of the following corporations: Comfax Communications Industries, Inc.; Enviornmental Pollution Research Corp.; Ferronics, Inc.; Fiberstatics Corp.; Galaxy Group Inc.; Jaymee Industries, Inc.; Professional Data Sciences; Project 7 Inc.; and Schnur Appel,In

2 The trustee initially objected to two "purchases cancelled in the accounts of Martin Harris and Nathan Dombers, but has since withdrawn his objections as to these claimants.

SIPC advances, and (iii) the values of a substantial number of securities held by debtor's customers would be severely depressed by debtor's withdrawal as a market maker for such securities.

Accordingly, the trustee urges that those February 2d transactions be treated as a nullity and be reversed on the debtor's books and records.

Of the 27 transactions objected to by the trustee, the customer-respondents involved in 20 transactions oppose the trustee's application. Those customer-respondents do not deny that a sale of the securities in question was purportedly effected for their benefit, but in every case assert that the alleged sale was <u>bona fide</u>, and, in some instances, claim that the trustee lacks power to reverse the alleged sale. Certain of the customer-respondents assert that their transactions were effected prior to February 2d, 1972, and these claims will be discussed separately.[3] Except as to these claimants, no material issue of fact is raised and the rights of the parties may be determined on the basis of the uncontroverted facts as set forth in the trustee's said application and his affidavits, and that of the National Association of Security

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[3] Accounts of Abe Baron and Mildred Katz, Herman Knoller, Elyse Lacher and Robert Weinger, see p.15, <u>infra</u>.

Dealers, Inc., submitted in support of the trustee's motion to reverse the February 2d entries and nullify the transactions in question.

The following facts are uncontroverted: The debtor was underwriter or co-underwriter and a principal market maker for the securities labelled by the trustee as the "Salmon Nine". Shares of 8 of the "Salmon Nine" corporations constituted the debtor's principal assets for net capital purposes. The ninth, Jaymee, was not sold to the public until January 1972. The trustee's affidavit in support of the motion has attached as an exhibit (1) the "bid" and "asked" quotations by each of the market makers (including the debtor) for each security of the "Salmon Nine" for the period January 31, 1972, through February 2, 1972, the last day the debtor engaged in business, and (2) the high "bid" and "asked" quoted by other market makers each day from February 3, 1972 to February 29, 1972, after the debtor ceased doing business. It appears from this exhibit that as soon as the debtor ceased to act as a market maker for the "Salmon Nine", the "bid" and "asked" price for each of the securities plummeted. For several days after February 2d, other broker-dealers published virtually no quotations whatsoever, and when they resumed, the "bid" and "asked" prices were well below the February 2d level. For illustratio

the average bid on Comfax from January 31 through February 2 was 23-3/8, but from February 3 through February 11 was 3-7/8. The average bid on Fiberstatics for the first period was 14-3/8 and for the second period, 4-1/8. Project 7 had an average bid of 11 for the first period, and 5/8 for the period after February 2d. This sharp decrease was true in the case of each security included in the "Salmon Nine".

Of great importance to a decision, and probably the crux of it, is the action taken by the National Association of Security Dealers, Inc. ("NASD"), of which debtor was a member, during the period January 28, 1972 through February 2d, 1972, in reviewing the debtor's capital position in order to determine whether the debtor was in compliance with the net capital rules to which broker-dealers are subject pursuant to §15(c)(3) of the Securities Exchange Act of 1934 (the "1934 Act"), as appears from the affidavit of Jerome S.Pilpel, an Assistant Director of "NASD" for District No. 12, submitted in support of the trustee's motion.

On January 28, 1972, "NASD" examiners made an examination at debtor's offices, of the debtor's December 31, 1971 trial balance and supporting schedules for the purpose of computing the debtor's net capital position. They noted that a significant portion of the debtor's capital consisted of long positions in the eight of the "Salmon Nine" for which

it was then acting as market maker.[4] Thereupon they investigated the net capital positions of most of the other market makers in these eight securities to determine their liquidity, that is whether debtor could, if the need arose, sell these securities to such firms at or near the prevailing prices. Based upon their examination of the debtor and the aforesaid related investigation, the NASD came to the conclusion that because of their own net capital positions, only a minimal amount of said securities had any market value. Because of this illiquidity of each of the eight securities in question, the NASD concluded that there was a market for only 1,000 shares per each market maker for the security and that the balance of the shares were without value. Accordingly, the NASD permitted the debtor in computing its net capital position, to include in net capital only 1,000 shares of each of the eight securities multiplied by the number of market makers for that security. The limited number of shares thus included in the debtor's capital were valued at their then purported market value, less 30% to allow for market fluctuations, in accordance with normal NASD procedures.

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[4] The Jaymee underwriting was not closed until late January 1972, and, therefore, the Jaymee shares were not reflected in debtor's capital position on December 31, 1971.

On January 31, 1972, representatives of NASD advised debtor's president and another of its principals, that debtor's capital position was illiquid and the securities substantially valueless, that the NASD had determined that debtor was in violation of its net capital rules and that it would require additional capital in excess of $1 million to be in compliance with said rules.

On February 2d, NASD representatives reviewed debtor's January 31, 1972 trading, investment and subordinated accounts, and found that debtor's position had deteriorated since December 31, 1972. Subsequently, a more complete review disclosed that based on debtor's January 31 figures (recognizing that only 1,000 shares per market maker for each of the eight securities in which debtor was a market maker had realizable value), additional capital in the amount of $1,391,395.46 would be required in order for debtor's aggregate indebtedness not to exceed its net capital by more than the 20 to 1 maximum ratio then permitted under the 1934 Act.

We come now to the February 2d transactions which are the subject of the trustee's motion. On that date, instead of trying to improve its net capital position through sales of its securities, the debtor purported to

effect, <u>for its own account</u>, purchases of 43,150 shares of stock of the Salmon Nine from selected customers at the prices it had been quoting as a market maker, for a total purchase price of $442,515.80. If these alleged "purchases" were valid, the consequence was a worsening of the debtor's already inadequate position by $442,515.80. Additionally, on the same day the debtor purported to "cancel" previous sales to customers of a total of 28,250 shares of the Salmon Nine, and these so-called cancellations, viewed as "sales", if valid, would further impair the debtor's capital position by $262,375.00.

The total of 145 "sales" by customers to the debtor and cancellation of prior customer purchases which allegedly took place on February 2d, stands out in marked contrast to the average of 33 such transactions during each of the preceding 30 trading days.

At 5:30 A.M. on February 2d, debtor sent a telegram to the Securities and Exchange Commission stating that "it appears that our net capital is less than the minimum required to be maintained by the applicable net capital rules of the NASD".

But several things make it perfectly clear, and I find, that prior to February 2d the debtor knew that the liquidation of its business was both inevitable and imminent

and that the quoted values of the "Salmon Nine" would dip sharply with its withdrawal as a market maker for those securities. If it did not know sooner, it certainly knew on January 31, 1972, that it was at least $1 million dollars short of being in capital compliance.

Knowledge that it was not in capital compliance certainly did not come to the debtor for the first time at 5:30 P.M. on February 2d when it dispatched the aforesaid telegram to the SEC. If it knew the facts concerning its capital position at 5:30 P.M., then it assuredly was well aware of them when it purported to enter into the transactions earlier in the day which merely worsened its capital position. Under all the uncontradicted circumstances, the motivation for the February 2d transactions is transparent: the positions of certain customers in shares of the "Salmon Nine" were converted into cash credit balances <u>at pre-liquidation prices</u> so that cash claims would be paid with advances to be made by the Securities Investor Protection Corporation ("SIPC").

The debtor ceased doing business after February 2, 1972, which fell on a Wednesday. On the following Monday, February 7, 1972, the SEC instituted an action to enjoin the debtor and two of its principals from engaging in acts alleged to constitute violations of the 1934 Act. At the

same time, SIPC applied to the court for a decree adjudicating that the customers of the debtor were in need of protection under the Securities Investor Protection Act and appointing a trustee pursuant to §5(b)(3) of said Act. On the said day, February 7, 1972, the court permanently enjoined the debtor and its two principals as requested by the SEC, granted the application of SIPC, decreed the debtor's customers were in need of protection, and appointed John C. Fontaine, trustee to liquidate the business of the debtor.

It is upon the foregoing facts and circumstances that the trustee bases his present motion to nullify the February 2d transactions and in effect, reverse the entries in debtor's books to reflect the positions of the respondents immediately preceding the making thereof. The trustee takes the position that the transactions are fraudulent and void under applicable provisions of the Bankruptcy Act and under State law, specifically under §67d of the Bankruptcy Act and §70e of said Act and the New York Debtor and Creditor Law §§270-281.

There were 145 February 2d transactions involving the "Salmon Nine". By application dated January 11, 1973, and notice of motion dated March 29, 1973, the trustee moved to nullify and reverse 116 of the 145 transactions. By decision

dated August 8, 1974 I found the February 2d sales allegedly made by certain of debtor's customers of one or more of the "Salmon Nine" to the debtor's trading account to be fraudulent transactions under §§67d and 70e of the Bankruptcy Act and granted the trustee's motion for summary judgment.

The 27 remaining February transactions* are the subject of the present application and motion.

It would unduly prolong this decision to again set forth in detail the reasons why I held the February 2d transactions to be fraudulent under §§67d and 70e of the Act. The basic facts upon which my decision of August 8, 1973 is predicated are identical with those presently before the court, and accordingly, I incorporate herein pages 11 through 27 of my said decision of August 8, 1973. For the reasons therein set forth, I find the remaining February 2d transactions which are the subject of the present application and motion to be fraudulent under §67d of the Act and under New York Debtor and Creditor Law §§270-281 and §70e of the Act.

The responsive pleadings filed by the respondents herein raise a number of questions and several have submitted supporting memorandum. Many points presented are trivial and call for no discussion.

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* See n.2, *supra.*

The principal arguments of respondents fall into several general categories: Firstly, it is argued that the trustee's position in seeking to reverse the February 2d transactions is contrary to the purpose of SIPA. There is no validity to this point of view. It is true that SIPA was intended to afford greater protection to customers than they enjoyed under §60e of the Bankruptcy Act, essentially by providing a limited form of insurance for customer claims for cash and securities. But SIPA was not intended to make the fraudulent transfer provisions of the Bankruptcy Act inoperative as to stocbroker-debtors in SIPA proceedings. While SIPA was intended to protect customers there is nothing in its provisions to indicate that less preferred creditors are to be denied the protection of the provisions which bar a debtor from making fraudulent transfers at their expense.

Secondly, as to be expected, it is asserted that the February 2d transactions were made for a "fair consideratio based on the argument that "fair consideration" is measured by the quoted market value on the day of the transaction.[5] But market quotations are not conclusive evidence and must give way before other evidence.[6] The evidence in the instant

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[5] Citing such cases as Castellano v. Osborne, 16 F.2d 187 (2d Cir.1926); Cowan v. Guidry, 274 F.Supp. 22 (E.D.La.1967); Associated Seed Growers, Inc. v. Geib, et al., 125 F.2d 683 (4th Cir.1942); Halsey v. Winant, 258 N.Y. 512 (1932).

[6] Application of Marcus, 273 App.Div.725, 79 N.Y.S.2d 76; Matter of Kaufmann, Alsberg & Co., v. H.L.Green Co.,Inc., 15 App. Div. 2d 468, 222 N.Y.S. 2d 305.

case clearly shows that market value had no relationship to reality and that the securities in question simply could not be sold at the purported "market" quotation.

Moreover, since I have already determined that the February 2d transactions were made with actual intent as distinguished from intent presumed in law, to hinder, delay or defraud either existing or future creditors,[7] the question of "unfair consideration" is, at least in that context, irrelevant.

Thirdly, several of the respondents assert the bona fide nature of their transactions. As I have already indicated, lack of the respondents' good faith is not essential to the determination of the issue of fraud. The transferee's good faith becomes relevant only when the question is whether the trustee can recover some or all of the property transferred.[8]

Fourthly, it is argued that the trustee's objections raise questions of fact. The respondents do not quarrel with the basic facts alleged by the trustee. They disagree with the conclusions to be drawn from these facts.

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7 Bankr. Act §67(d)(2)(d).

8 4 Collier on Bankruptcy (14th Ed.) §67.37. See also In re Peoria Braumeister Co., 138 F.2d 520 (7th Cir.1943), and In re Allied Development Corporation, 435 F.2d 372 (7th Cir.1970

The function of the summary judgment procedure is to promptly dispose of actions to which there is no genuine issue of fact, although such an issue is raised by the pleadings The object of the motion, as observed by the late Justice Benjamin Cardozo, is to separate what is formal or pretended and what is genuine and substantial, so that only the latter may subject a suitor to the burden of a trial.[9] If there is no genuine issue to a material fact, the parties are not entitled to a trial and judgment may be awarded by applying the law to the undisputed facts.[10]

Unsupported assertions that questions of fact exist are not enough to defeat a motion for summary judgment.[11] And, a mere denial of facts alleged by the moving party does not raise a triable issue of fact.[12] Federal Rule of Civil Procedure 56(e) provides, in part:

> "Where a motion for summary judgment is made and supported as provided in this rule an adverse party may not rest on mere allegations or denials of his pleading, but his response, by affidavit or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him". (emphasis added)

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9 Richard v. Credit Suisse, 242 N.Y.346 (1926).

10 William J. Kelly Co., v. R.F.C., 172 F.2d 865 (1st Cir. 1949); SEC v. Payne, 35 F.Supp.,873 (S.D.N.Y. 1940).

11 Gulf Puerto Rico Lines v. Maicera Criolla,Inc., 309 F.Supp. 539 (D.C.P.R.1969); Bruce Construction Corporation v. United States, 242 F.2d 873 (5th Cir.1957).

12 Engl.v.Aetna Life Insurance Company, 139 F.2d 469 (2d Cir.1943); Ortiz v. National Liberty Insurance Co., 75 F.Supp 550 (D.C.P.R.1948).

Certainly, if Fed.R.Civ.P. 56(e) does not shift the burden of persuasion, it does shift the burden of going forward with the evidence. The party opposing the motion for summary judgment must present facts in proper form - conclusions of law will not suffice; any facts asserted by the opposing party must be material, of a substantial nature, not fanciful, frivolous, gauzy, or merely suspicious.[13] The affidavit in opposition is no place for ultimate facts and conclusions of law.[14] Statements made on "information and belief" will be disregarded.[15]

Finally, certain of the respondents[16] assert that the transactions which concerned them occurred prior to February 2d, 1972, and since the trustee has elected to seek avoidance of transactions which were actually consummated on February 2d, 1972, I think that these respondents raise an issue which requires clarification. Consequently, as to

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13. Moore's Manual of Federal Practice and Procedure, §17-10 [3], and cases cited therein.

14. Englehard Industries v. Research Instrumental Corp., 324 F.2d 347 (9th Cir.1963), cert.denied, 377 U.S.923 (1964).

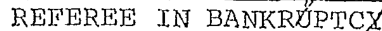
15. Automatic Radio Mfg. Co., v. Hazeltine Research Inc., 339 U.S. 827, 831 (1950); State of Washington v. Maricopa County, 143 F.2d 871 (9th Cir. 1944).

16. Herman Knoller, Abe Baron, Elyse Lacher, Robert Weinger, Mildred Katz.

these claimants, the matter will be set down for hearings by the trustee, and if the proof is that the transactions occurred prior to February 2d, the motion will be denied as to them. If, however, the proof is that the transactions indeed took place on February 2d, the motion will be granted as to them.

With the exceptions just noted, the motion for summary judgment is granted and the trustee will settle an order in conformity herewith on ten days' notice to all respondents.

DATED: New York, New York
February 5th, 1974



REFEREE IN BANKRUPTCY

CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPE FACE, AND TYPE STYLE REQUIREMENTS

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B), because this brief contains 13,460 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionately spaced typeface using Microsoft Word in 14-point Times New Roman font.

Dated: September 20, 2010
Washington, DC

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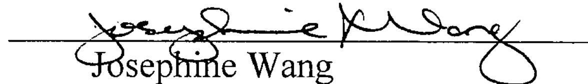
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In re: BERNARD L. MADOFF INVESTMENT SECURITIES LLC, Debtor.	**CERTIFICATE OF SERVICE** No. 10-2378-BK(L)

I, Josephine Wang, hereby certify that on September 20, 2010, I caused true and correct copies of the Brief of the Securities Investor Protection Corporation to be served upon the parties who receive electronic service through CM/ECF, as listed on Schedule A, and two copies to be served by prepaid United States Express Mail, upon the party as listed on Schedule B.



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Schedule B

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