

11-5207-BK

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In the Matter of: Bernard L. Madoff Investment Securities LLC,

Debtor.

IRVING H. PICARD, Trustee,

Plaintiff-Appellant,

~and~

SECURITIES INVESTOR PROTECTION CORPORATION,

Intervenor.

~against~

**HSBC BANK PLC, HSBC SECURITIES SERVICES (LUXEMBOURG) S.A., HSBC
BANK BERMUDA LIMITED, HSBC PRIVATE BANK (SUISSE) S.A., HSBC PRIVATE
BANKING HOLDINGS (SUISSE) S.A., HSBC BANK (CAYMAN) LIMITED, HSBC
SECURITIES SERVICES (BERMUDA) LIMITED, HSBC BANK USA, N.A., HSBC
INSTITUTIONAL TRUST SERVICES (BERMUDA) LIMITED, HSBC SECURITIES
SERVICES (IRELAND) LIMITED, HSBC INSTITUTIONAL TRUST SERVICES
(IRELAND) LIMITED, HSBC HOLDINGS PLC,**

Defendants-Appellees,

ALPHA PRIME FUND LIMITED,

Defendant.

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

(caption continued on inside cover)

**BRIEF OF INTERVENOR
SECURITIES INVESTOR PROTECTION CORPORATION**

JOSEPHINE WANG
General Counsel

KEVIN H. BELL
Senior Associate General Counsel
for Dispute Resolution

CHRISTOPHER H. LAROSA
Senior Associate General Counsel – Litigation

Date: February 16, 2012
Washington, D.C.

SECURITIES INVESTOR
PROTECTION CORPORATION
805 Fifteenth Street, N.W., Suite 800
Washington, D.C. 20005
Telephone: (202) 371-8300

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, the Securities Investor Protection Corporation, Intervenor under 15 U.S.C. §78eee(d), certifies that it has no corporate parents, affiliates, and/or subsidiaries that are publicly held.

TABLE OF CONTENTS

	<u>PAGE</u>
TABLE OF AUTHORITIES	v
STATEMENT OF JURISDICTION.....	1
STATEMENT OF THE ISSUES.....	2
SUMMARY OF THE CASE.....	3
STATEMENT OF THE FACTS	5
SUMMARY OF THE ARGUMENT	7
ARGUMENT	10
I. AS THE BAILEE OF CUSTOMER PROPERTY, THE TRUSTEE HAS STANDING TO BRING HIS COMMON LAW CLAIMS.....	10
A. <u>Redington</u> remains good law	11
1. <u>Redington</u> 's Case History	11
2. <u>Redington</u> and the law of jurisdiction and stare decisis.....	13
B. <u>Redington</u> was correctly decided.....	16
1. The Trustee is the bailee of customer property	17
(a) Segregation requirements of Rule 15c3-3.....	17
(b) Origins of Rule 15c3-3.....	19
(i) Prior to 1938	19

TABLE OF CONTENTS

(cont.)

(ii)	1938 – Section 60e of the Bankruptcy Act.....	21
(iii)	1970 – SIPA.....	24
(iv)	1973 – Rule 15c3-3	25
(v)	1978 – Modifications to SIPA.....	28
(c)	Relationship between Rule 15c3-3 and SIPA.....	30
(d)	Applicability of federal common law	31
(e)	The Trustee as bailee under federal common law	35
(f)	The Trustee as bailee under New York law	36
(g)	The bailee’s intent is irrelevant	37
(h)	Ratable distribution is consistent with bailment.....	38
2.	As bailee, the Trustee has a posessory interest in Customer Property	39
3.	<u>Wagoner</u> and <u>Caplin</u> do not bar the Trustee’s suit.....	40
4.	The Trustee’s standing to sue is not limited by SIPA	44

TABLE OF CONTENTS

(cont.)

II. THE TRUSTEE HAS STANDING AS THE ENFORCER
OF SIPC’S SUBROGATION RIGHTS.....46

III. THE DISTRICT COURT’S STANDING DECISION IS
ERRONEOUS48

IV. SLUSA DOES NOT PREEMPT THE TRUSTEE’S CLAIMS52

 A. The Trustee’s Amended Complaint Is Not A
 “Covered Class Action”53

 B. The Trustee has not alleged securities fraud.....56

CONCLUSION58

CERTIFICATE OF COMPLIANCE WITH RULE 32(a)59

TABLE OF AUTHORITIES

<u>CASES:</u>	<u>PAGE</u>
<u>Ace American Ins. Co. v. First Choice Marine, Inc.</u> , 2010 WL 3125945 (M.D. Fla. July 29, 2010)	35
<u>Appleton v. First Nat. Bank</u> , 62 F.3d 791 (6 th Cir. 1995)	46, 48
<u>Anwar v. Fairfield Greenwich Ltd.</u> , 728 F.Supp.2d 372 (S.D.N.Y. 2010)	52, 57
<u>In re A.R. Baron & Co.</u> , 280 B.R. 794 (Bankr. S.D.N.Y. 2002)	10
<u>Matter of Atkeison</u> , 446 F.Supp. 844 (M. D. Tenn. 1977)	38
<u>In re Baldwin-United Corp. Litig.</u> , 765 F.2d 343 (2d Cir. 1985)	14
<u>Baldwin v. Hill</u> , 315 F.2d 738 (6 th Cir. 1963)	40
<u>In re Banco Santander Secs.- Optimal Litigation</u> , 732 F.Supp.2d 1305 (S.D. Fla. 2010), <u>aff'd sub nom.</u> , <u>Inversiones Mar Octava Limitada v. Banco Santander S.A.</u> , 439 Fed. Appx. 840 (11 th Cir. 2011)	57
<u>Bank of New York v. Amoco Oil Co.</u> , 35 F.3d 643 (2d Cir. 1994)	37
<u>Baraket v. Holder</u> , 632 F.3d 56 (2d Cir. 2011)	14-15
<u>Bateman Eichler, Hill Richards, Inc. v. Berner</u> , 472 U.S. 299 (1985)	41, 42
<u>In re Bell & Beckwith</u> , 937 F.2d 1104 (6 th Cir. 1991)	47
<u>Boyd v. Henderson</u> , 555 F.2d 56 (2d Cir. 1977), <u>cert. den.</u> , 434 U.S. 927 (1977)	15
<u>Cacchillo v. Insmmed, Inc.</u> , 638 F.3d 401 (2d Cir. 2011)	13
<u>Calumet Paper Co. v. Haskell Show-Printing Co.</u> , 45 S.W. 1115 (Mo. 1898)	39

TABLE OF AUTHORITIES
(cont.)

<u>CASES:</u>	<u>PAGE</u>
<u>Caplin v. Marine Midland Grace Trust Co. of New York,</u> 406 U.S. 416 (1972).....	40-41
<u>Carroll v. Lessee of Carroll,</u> 57 U.S. 275 (1853).....	15
<u>Carver v. City of NY,</u> 621 F.3d 221 (2d Cir. 2010)	13
<u>City of New York v. Mickalis Pawn Shop LLC,</u> 645 F.3d 114 (2d Cir. 2011) 13, 14	
<u>Donk Bros. Coal & Coke Co. v. Kinealy,</u> 83 Mo. App. 40 (Mo. Ct. App. 1900).....	39
<u>Elk Grove Unified School Dist. v. Newdow,</u> 542 U.S. 1 (2004)	13
<u>Fireman’s Fund Ins. Co. v. Panalpina, Inc.,</u> 153 F.Supp.2d 1339 (S.D. Fla. 2001).....	35
<u>Fisher v. Int’l Ry. Co.,</u> 182 N.Y.S. 313 (N.Y.Sup.Ct. 1920).....	43
<u>Herrington v. Verrilli,</u> 151 F.Supp.2d 449 (S.D.N.Y. 2001).....	37
<u>Jennifer Matthew Nursing & Rehab. Ctr. v.</u> <u>U.S. Dep’t of Health & Human Servs.,</u> 607 F.3d 951, 955 (2d Cir. 2010)	14
<u>Jimenez v. Walker,</u> 458 F.3d 130 (2d Cir. 2006), <u>cert. den.,</u> 549 U.S. 113 (2007)15	
<u>Kamen v. Kemper Fin. Servs., Inc.,</u> 500 U.S. 90 (1991).....	32
<u>King Grain Co. v. Caldwell Mfg. Co.,</u> 820 F.Supp. 569 (D. Kans. 1993).....	40
<u>LaSala v. Bank of Cypress Public Co. Limited,</u> 510 F.Supp.2d 246 (S.D.N.Y. 2007)	54, 55

TABLE OF AUTHORITIES
(cont.)

<u>CASES:</u>	<u>PAGE</u>
<u>LaSala v. Bordier Et Cie</u> , 555 U.S. 1028 (3d Cir. 2008), cert. dismissed, 555 U.S. 1028 (2008).....	54, 55, 56
<u>LaSala v. Lloyd’s TSB Bank, PLC</u> , 514 F.Supp.2d 447 (S.D.N.Y. 2007)	54, 55
<u>LaSala v. UBS AG</u> , 510 F.Supp.2d 213 (S.D.N.Y. 2007).....	54, 55
<u>Lee v. Marsh & McLennan Companies</u> , 2007 WL 704033 (S.D.N.Y. Mar. 7, 2007).....	54, 55
<u>Lerner v. Fleet Bank, N.A.</u> , 318 F.3d 113 (2d Cir. 2003)	13
<u>Marsh v. Rosenbloom</u> , 499 F.3d 165, 181 (2d Cir. 2007).....	32
<u>McCutcheon v. Charleston Boatworks, Inc</u> , 2010 WL 2431017 (D.S.C. June 14, 2010)	35
<u>Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit</u> , 547 U.S. 71 (2006).....	52
<u>Ming Shi Xue v. Board of Immigration Appeals</u> , 439 F.3d 111 (2d Cir. 2006)	16
<u>Murray v. McGraw (In re Bell & Beckwith)</u> , 821 F.2d 333 (6 th Cir. 1987).....	43
<u>Nat’l R.R. Passenger Corp. v. Nat’l Assn. of Railroad Passengers</u> , 414 U.S. 453 (1974).....	51
<u>Paragon Oil Co. v. Republic Tankers, S.A.</u> , 310 F.2d 169 (2d Cir. 1962), cert. den. sub nom., <u>Yacimientos Petroliferos Fiscales v. Paragon Oil Co.</u> , 372 U.S. 967 (1963).....	40
<u>Peltz v. SHB Commodities, Inc.</u> , 115 F.3d 1082 (2d Cir. 1997).....	42

TABLE OF AUTHORITIES
(cont.)

<u>CASES:</u>	<u>PAGE</u>
<u>Pension Committee of the University of Montreal Pension Plan v. Banc of America Secs., LLC</u> , 750 F.Supp.2d 450 (S.D.N.Y. 2010).....	57
<u>Perma Life Mufflers, Inc. v. Int’l Parts Corp.</u> , 392 U.S. 134 (1968), <u>rev’d on other grounds</u> , <u>Copperweld Corp. v. Independence Tube Corp.</u> , 467 U.S. 752 (1968).....	41-42
<u>Picard v. Taylor (In re Park South Secs., LLC)</u> , 326 B.R. 505 (Bankr. S.D.N.Y. 2005)	10
<u>Pinter v. Dahl</u> , 486 U.S. 622 (1988)	41, 42
<u>Rahilly v. Wilson</u> , 20 F. Cas. 176 (D. Minn. 1872), <u>aff’d in part</u> , 20 F.Cas. 179 (C.C.D. Minn. 1873)	39
<u>Redington v. Touche Ross & Co.</u> , 428 F.Supp. 483 (S.D.N.Y. 1977)	11, 12
<u>Redington v. Touche Ross & Co.</u> , 592 F.2d 617 (2d Cir. 1978), <u>rev’d on other grounds</u> , 442 U.S. 560 (1979).....	2, 8, 10, 11, 12, 31, 32, 39, 48
<u>Redington v. Touche Ross & Co.</u> , 612 F.2d 68 (2d Cir. 1979)	13
<u>RGH Liquidating Trust v. Deloitte & Touche LLP, et al.</u> , 955 N.E.2d 329 (N.Y. 2011)	55
<u>Romano v. Kazacos</u> , 609 F.3d 512 (2d Cir. 2010)	53
<u>Ross v. Bolton</u> , 904 F.2d 819 (2d Cir. 1990).....	42, 44
<u>S & R Co. of Kingston v. Latona Trucking, Inc.</u> , 159 F.3d 80 (2d Cir. 1998), <u>cert. dismissed</u> , 528 U.S. 1058 (1999)	15
<u>SEC v. Albert & Maguire Sec. Co.</u> , 378 F. Supp. 906 (E.D. Pa. 1974)	23

TABLE OF AUTHORITIES
(cont.)

<u>CASES:</u>	<u>PAGE</u>
<u>SEC v. Albert & Maguire Sec. Co. Inc.</u> , 560 F. 2d 569 (3d Cir. 1977)	46
<u>Shearson Lehman Hutton, Inc. v. Wagoner</u> , 944 F.2d 114 (2d Cir. 1991)	5, 41
<u>Sinochem Int’l Co. v.</u> <u>Malaysia Int’l Shipping Corp.</u> , 549 U.S. 422 (2007)	14
<u>SIPC v. BDO Seidman, LLC</u> , 49 F.Supp.2d 644 (S.D.N.Y. 1999), <u>aff’d in part, question certified</u> , 222 F.3d 63 (2d Cir. 2000), <u>aff’d</u> , 245 F.3d 174 (2d Cir. 2001)	10
<u>SIPC v. BDO Seidman, LLC</u> , 222 F.3d 63 (2d Cir. 2000).....	16
<u>SIPC v. Vigman</u> , 803 F.3d 1513 (9th Cir. 1986)	46, 48
<u>Smith v. Arthur Andersen LLP</u> , 421 F.3d 989 (9th Cir. 2005)	54
<u>In re Sokolowski</u> , 205 F.3d 532 (2d Cir. 2000)	16
<u>Steel Co. v. Citizens for a Better Environment</u> , 523 U.S. 83 (1998).....	52
<u>Tepper v. Chicester</u> , 285 F.2d 309 (9 th Cir. 1960)	43
<u>Thompson v. County of Franklin</u> , 15 F.3d 245 (2d Cir. 1994)	13
<u>Thyssen Steel Co. v. M/V Kavo Yerakas</u> , 50 F.3d 1349 (5 th Cir. 1995).....	35
<u>Touche Ross & Co. v. Redington</u> , 442 U.S. 560 (1979)	12
<u>United States v. Bell</u> , 524 F.2d 202 (2d Cir. 1975)	15
<u>United States v. Currency \$716,502.44</u> , 2008 WL 5158921 (E. D. Mich. Dec. 5, 2008)	40
<u>United States v. Kimbell Foods, Inc.</u> , 440 U.S. 715 (1979).....	33

TABLE OF AUTHORITIES
(cont.)

<u>CASES:</u>	<u>PAGE</u>
<u>United States v. Perea</u> , 986 F.2d 633 (2d Cir. 1993)	39, 40
<u>United States v. Ruiz</u> , 536 U.S. 622 (2002).....	14
<u>Wallis v. Pan. Am. Petroleum Corp.</u> , 384 U.S. 63 (1966).....	32
<u>Warth v. Seldin</u> , 422 U.S. 490 (1975)	13
<u>Wilkinson v. Russell</u> , 182 F.3d 89 (2d Cir. 1999), <u>cert. den.</u> , 528 U.S. 1155 (2006).....	16
<u>Xpeditior Creditor Trust v. Credit Suisse First Boston (USA) Inc.</u> , 341 F.Supp.2d 258 (S.D.N.Y. 2004)	57

STATUTES AND RULES:

Securities Investor Protection Act (1970), 15 U.S.C. §

78fff(c)(2)(C)(i)	25
78fff(c)(2)(C)(ii)	25
78fff(c)(2)(C)(iii)	25

Securities Investor Protection Act, as amended, 15 U.S.C. §

78fff(a)(1)(B)	31, 34, 37
78fff(b)	31, 47
78fff-1(a)	31, 44, 45, 48, 55
78fff-1(b).....	31, 55
78fff-2(c)(1)	29, 42, 48
78fff-2(c)(2)	29
78fff-3(a)	29, 46, 50, 51
78fff-4(a)(4)	50
78fff-4(c)	50
78kkk(g)	27
78lll(2).....	38

TABLE OF AUTHORITIES
(cont.)

<u>STATUTES AND RULES:</u>	<u>PAGE</u>
Securities Investor Protection Act, as amended, 15 U.S.C. §	
78lll(3).....	29
78lll(4).....	6, 29, 37, 43, 44
78q.....	11
United States Bankruptcy Act, 11 U.S.C. (repealed effective 1979) §	
96e.....	21-24, 26, 33
96e(1).....	22
96e(2).....	22
96e(3).....	24
96e(4).....	22, 23, 24
United States Bankruptcy Code, as amended, 11 U.S.C. §	
362(a).....	42, 47
362(a)(3).....	42, 50
541(a).....	47
541(a)(1).....	42, 47
542.....	47
542(a).....	50
544.....	44
547.....	44
548.....	44
704.....	55
704(a)(1).....	31
Securities Litigation Uniform Standards Act, 15 U.S.C. §	
77p(f)(2)(A)(i)(I).....	53, 56
77p(f)(2)(C).....	53, 55
78bb(f)(5)(B)(i)(I).....	53, 56
78bb(f)(5)(D).....	53, 55

TABLE OF AUTHORITIES
(cont.)

<u>STATUTES AND RULES:</u>	<u>PAGE</u>
Securities and Exchange Commission Rule (1973), 17 C.F.R. §240.	
15c3-3(j)(1)	27
15c3-3(j)(2)	28
Securities Exchange Act of 1934, 15 U.S.C. §	
78q	11
Securities and Exchange Commission Rule, 17 C.F.R. §240.	
15c3-2.....	27
15c3-3.....	2, 8, 17-31, 33-38, 43, 49
15c3-3(a)	18
15c3-3(a)(6)	28
15c3-3(a)(8)	28
15c3-3(b)	17, 30
15c3-3(c)	17, 30
15c3-3 (c)(1)	17
15c3-3(c)(3)	17
15c3-3 (d).....	17, 30
15c3-3(e)	28, 30
15c3-3(e)(1)	18
15c3-3(j)(1)	27
15c3-3(j)(2)	28
17a-5.....	11
28 U.S.C. §	
1291.....	2
1334(b)	1
Federal Rules of Appellate Procedure	
4(a)(1)(A).....	1

TABLE OF AUTHORITIES
(cont.)

<u>STATUTES AND RULES:</u>	<u>PAGE</u>
Federal Rules of Civil Procedure §	
17(a)	32
54(b)	1, 2, 5
 <u>RELEASES:</u>	
Exchange Act Release No. 9622, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,801 (May 31, 1972).....	27
Amendments to Conform to the Securities Investor Protection Act of 1970, 44 Fed. Reg. 1974 (Jan. 9, 1979)	30
 <u>LEGISLATIVE MATERIALS:</u>	
H.R. Rep. No. 91-1613 (1970).....	25
S. Rep. No. 95-763 (1978), <u>reprinted in</u> 1978 U.S.C.C.A.N. 765	29
S. Rep. No. 105-182 (1998)	54
Report of Special Study of Securities Markets of the Securities and Exchange Commission, H. R. Doc. No. 88-95 (1963)	23, 24
 <u>TREATISES:</u>	
8A Am. Jur. 2d Bailments § 165.....	43
8 C.J.S. <u>Bailments</u> § 100 (2005)	37
3 <u>Collier on Bankruptcy</u> (14 th ed. 1977)	
¶60.71	20

TABLE OF AUTHORITIES
(cont.)

<u>TREATISES:</u>	<u>PAGE</u>
¶60.72	20
¶60.73	22
¶60.74	23
Richard A. Lord, 19 <u>Williston on Contracts</u> § 53:2 (4 th ed. 2011)	35
Richard A. Lord, 19 <u>Williston on Contracts</u> § 53:6 (4 th ed. 2011)	36
9 N.Y. Jur.2d Bailments and Chattel Leases § 91	40
 <u>PUBLICATIONS AND PERIODICALS</u>	
Michael E. Don & Josephine Wang, <u>Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers</u> , 12 Cardozo L. Rev. 508 (1990).....	17, 33
Michael P. Jamroz, <u>The Customer Protection Rule</u> , 57 Bus. Law. 1069 (2002)	18, 19, 27, 30, 31
Steven D. Lofchie, <u>Lofchie’s Guide to Broker-Dealer Regulation</u> (3d ed. 2005).....	18
Marc McAllister, <u>Dicta Redefined</u> , 47 Williamette L. Rev. 161 (2011).....	15
Charles H. Meyer, <u>The Law of Stockbrokers and Stock Exchanges</u> (1931)	21
Norman J. Singer, J.D. Shambie Singer, 2A <u>Statutes and Statutory Construction</u> (7 th ed. 2007).....	45
N. Wolfson, R. Phillips & T. Russo, <u>Regulation of Brokers, Dealers and Securities Markets</u> (1977).....	26

STATEMENT OF JURISDICTION

The United States District Court for the Southern District of New York (“District Court”) exercised jurisdiction over these cases pursuant to 28 U.S.C. § 1334(b). On July 28, 2011, the District Court entered an order granting Appellees’ motions to dismiss Counts 20 – 24 of the Amended Complaint of Appellant Irving H. Picard (“Trustee”), trustee for the consolidated liquidation under the Securities Investor Protection Act (“SIPA”), 15 U.S.C. §§ 78aaa et seq., of Bernard L. Madoff Investment Securities LLC (“BLMIS”) and Bernard L. Madoff (“Madoff”).

These cases arise out of a single amended complaint filed in the United States Bankruptcy Court for the Southern District of New York (“Bankruptcy Court”), that were docketed as separate cases in the District Court (Nos. 1:11-cv-763 (JSR) and 1:11-cv-836 (JSR)), upon the filing of separate motions for withdrawal. The District Court combined the cases for purposes of its proceedings and, on December 8, 2011, it entered a single stipulated order directing the Clerk of the Court to enter a separate final judgment pursuant to Rule 54(b) reflecting the dismissals as to Counts 20 – 24. The Clerk entered that judgment on December 12, 2011. On the following day, the Trustee filed separate notices of appeal in each of the two cases, resulting in the instant appeals. Pursuant to Rule 4(a)(1)(A) of the Federal Rules of Appellate Procedure, the appeals are timely.

This Court has jurisdiction pursuant to 28 U.S.C. § 1291 and Rule 54(b) of the Federal Rules of Civil Procedure.

STATEMENT OF THE ISSUES

The instant motion presents the following issues:

1. Whether the Trustee has standing to bring common law claims as the bailee of “customer” property where:

a. The Second Circuit’s decision in Redington v. Touche Ross & Co., 592 F.2d 617 (2d Cir. 1978), rev’d on other grounds, 442 U.S. 560 (1979) (“Redington”), which recognized that a SIPA trustee has standing in that capacity, remains controlling law; and

b. Redington was properly decided, because Securities and Exchange Commission (“SEC” or “Commission”) Rule 15c3-3, 17 C.F.R. § 240.15c3-3 (“Rule 15c3-3”), SIPA, and the contracts between a broker-dealer and its customers create a bailment relationship under applicable law and because, as the successor bailee in that relationship, the Trustee has standing to sue third parties for recovery of the bailed customer property.

2. Whether the Trustee has standing to bring his common law claims as the enforcer of SIPC’s subrogation rights where a purpose of a SIPA proceeding is to enforce rights of subrogation as provided in SIPA, SIPC has

subrogation rights based upon its advances of funds for customers, and SIPC has assigned to the Trustee enforcement of its rights.

3. Whether the Securities Litigation Reform Act (“SLUSA”) is inapplicable here because this case does not qualify as a “covered class action” within the meaning of the statute and because the Trustee does not allege, and his suit does not depend upon allegations of, securities fraud, as required by the statute.

SIPC submits that the Trustee has standing and SLUSA does not apply.

STATEMENT OF THE CASE

This appeal arises from the dismissal for lack of standing of common law causes of action brought by the Trustee against, among others, a group of defendants who the Trustee alleges knowingly participated in, and helped to perpetuate, the massive Ponzi scheme operated by Madoff. On July 15, 2009, the Trustee filed a Complaint in the Bankruptcy Court where the case was docketed as Adv. No. 09-1364 and assigned to the Honorable Burton R. Lifland.

The Trustee filed an Amended Complaint on December 5, 2010, naming, among others, a group of entities linked to HSBC (collectively “HSBC”),¹

¹ The HSBC defendants include HSBC Bank plc, HSBC Holdings plc, HSBC Securities Services (Luxembourg) S.A., HSBC Institutional Trust Services (Ireland) Limited, HSBC Securities Services (Ireland) Limited, HSBC Institutional Trust Services (Bermuda) Limited, HSBC Bank USA, N.A., HSBC Securities Services (Bermuda) Limited, HSBC Bank (Cayman) Limited, HSBC Private

UniCredit S.p.A. (“UniCredit”), and Pioneer Alternative Investment Management Ltd. (“Pioneer” and, together with UniCredit “UCG”). (Joint Appendix (“A”) A19-A193.) Through his Amended Complaint, the Trustee asserted against all defendants traditional avoidance claims under the Bankruptcy Code and applicable state law, and also asserted five state law claims against certain defendants, including HSBC and UCG. (Id.)

On February 3 and 7, 2011, respectively, HSBC and UCG filed separate motions to withdraw the reference. The District Court created two separate cases, one for each motion (Nos. 1:11-cv-763 (JSR) and 1:11-cv-836 (JSR)), and assigned both matters to the Honorable Jed S. Rakoff, U.S.D.J., who then consolidated the cases for purposes of briefing. (A6, ECF Nos. 5, 7.) Through an order entered on April 14, 2011, and an opinion entered on April 25, 2011, Judge Rakoff granted both motions to withdraw, but did so for the limited purpose of addressing two questions: (1) whether the Trustee had standing to bring his state law causes of action against HSBC and UCG; and (2) whether the Trustee was barred by SLUSA from asserting his causes of action. (A573– A590.)

Fifteen of the forty defendants, including HSBC and UCG, then moved to dismiss the Trustee’s state common law claims for lack of standing and on the ground that those claims were preempted by SLUSA. (A9, ECF No. 24; A590.) In

Banking Holdings (Suisse) S.A., HSBC Private Bank (Suisse) S.A., HSBC Fund Services (Luxembourg) S.A., and HSBC Bank Bermuda Limited.

an Opinion and Order dated July 28, 2011, Judge Rakoff granted those motions as to HSBC and UCG, holding that the Trustee lacked standing to bring his common law claims and that those claims were barred by the doctrine of in pari delicto and by this Court's decision in Shearson Lehman Hutton, Inc v. Wagoner, 944 F.2d 114 (2d Cir. 1991). (Special Appendix ("SPA") SPA1-SPA26.) Judge Rakoff modified that order, nunc pro tunc, in a subsequent order entered on August 8, 2011. (SPA27-SPA 30.)

On December 8, 2011, pursuant to Rule 54(b) of the Federal Rules of Civil Procedure, Judge Rakoff entered an order finding that there was no just reason for delaying the appeal of his July 28, 2011 Opinion and Order, as modified, and directed the Clerk of Court to enter a final judgment dismissing the Trustee's common law claims. (SPA31-SPA38.) The Clerk entered the final judgment on December 12, 2011, and the Trustee timely filed a notice of appeal from that judgment on the following day. (SPA39.)

STATEMENT OF THE FACTS

The facts are stated in detail in the Trustee's memorandum and are summarized here. Through BLMIS, Madoff operated a massive Ponzi scheme. Madoff, however, did not act alone. HSBC played an indispensable role in the scheme by encouraging investment into an international network of feeder funds, including a number of the defendants named in this action, which then invested

their assets in BLMIS. (A35, ¶ 1.) HSBC was the marketer, custodian, and administrator of these funds. Its reputation and imprimatur provided essential reassurance to thousands of investors of the legitimacy of BLMIS, inducing those investors to pour the funds into BLMIS necessary to sustain the Ponzi scheme. (A37, ¶ 8.) Ultimately, HSBC funneled over \$8.9 billion into BLMIS's fraudulent investment advisory business. (A35, ¶ 1.) According to a September 2008 report commissioned by HSBC itself, at least 33% of the moneys invested in BLMIS were moved by and through HSBC. (Id.)

In exchange for these services, HSBC reaped an enormous financial windfall in the form of management, administrative, performance, advisory, distribution, custodial, and other fees. (A37, ¶ 8.) These fees were paid by BLMIS from stolen "customer property." (A40, ¶ 16.).² In this connection, the Trustee seeks recovery from HSBC of approximately \$6.6 billion. (A37, ¶ 1.) HSBC compounded the harm that it caused by developing and selling financial derivative products based upon BLMIS that resulted in the investment of additional monies in the Ponzi scheme. (A39, ¶ 14.)

In electing to provide these services, HSBC ignored indicia of fraud surrounding BLMIS. In annual due diligence reports, for example, HSBC

² Under SIPA, customer property is "cash and securities...at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." SIPA § 78III(4).

identified numerous badges of fraud, including Madoff's secrecy; his insistence on retaining custody of all assets under BLMIS management; his remarkable, and impossibly consistent, trading performance; BLMIS's untraditional fee structure; and the absence of a qualified auditor for such a purportedly substantial enterprise. (A39, ¶ 12.) HSBC also twice retained KPMG to perform due diligence on BLMIS. (A39, ¶ 14.) On both occasions, KPMG reported serious deficiencies and fraud risks, many already known to HSBC. (*Id.*) Despite knowledge that BLMIS was likely a fraud, HSBC allegedly decided to profit from it. (A39, ¶ 12.)

SUMMARY OF THE ARGUMENT

HSBC's challenge to the Trustee's standing to bring his common law claims represents an attempt by appellees to avoid responsibility for their role in perpetuating the largest, longest financial fraud in history, and the improper diversion of stolen customer funds. As the Trustee explains in detail in his Amended Complaint, HSBC funneled billions of dollars in fresh investments into the Ponzi scheme orchestrated by Bernard Madoff and operated through BLMIS, substantially prolonging the life of that scheme and greatly multiplying both the number of investors harmed and the extent of their injuries. In the process, having profited handsomely from their role in the scheme, they now seek to walk away from the staggering damage they caused while retaining the stolen customer money that they received, on the ground that they cannot be sued under the common law.

But the Trustee has standing to bring his common law claims as the bailee of customer property and the enforcer of SIPC's statutory and common law rights as subrogee of customers holding claims satisfied with advances from SIPC, inter alia. The standing of a SIPA trustee, as the bailee of customer property, to sue third parties has been conclusively recognized in this Circuit since 1978, when this Court decided Redington v. Touche Ross & Co., 592 F.2d 617 (2d Cir.). Although Redington was subsequently overturned on other grounds, the court's holding regarding standing was left undisturbed. As shown below, that holding remains good law today, and, with few exceptions, has been recognized as such by most courts that have considered it since Redington was decided.

Moreover, this Court's decision in Redington was correct. The contracts between brokerage customers and their broker-dealers, reinforced by SEC Rule 15c3-3, create a bailment relationship between customer and broker. In fact, as discussed below, Rule 15c3-3 represents an adaptation of traditional bailment law concepts to modern custodial practices in the securities industry. Under SEC Rule 15c3-3, and SIPA, a SIPA trustee assumes the broker-dealer's position as bailee with respect to customer property. With certain modifications, the trustee enjoys all of the broker's former rights and duties as bailee, including the bailee's universally-recognized right to sue third parties for recovery of the bailed property. Under applicable law, that right is not subject to the defense of in pari delicto and

is not limited by this Court's decision in Wagoner. The Supreme Court has long held that in pari delicto does not apply where its application would frustrate federal statutory or regulatory objectives, particularly the investor protection goal underlying all of the securities laws. Under SIPA, customers share ratably in customer property until their claims are fully satisfied. Recovery of such property by certain customers, as bailors, outside the context of the SIPA liquidation, would prevent non-recovering customers from receiving their ratable share of the recovered customer property, and thus would utterly frustrate SIPA's scheme of equal distribution. As a result, the SIPA trustee, as bailee, not the customer/bailors, can be the only party to sue for the recovery of customer property. It would thwart public policy for the SIPA trustee to be barred by the doctrine of in pari delicto. Application of that bar against the only party – the SIPA trustee - able to sue culpable third parties would excuse those parties of responsibility for their conduct, at the expense of the innocent customer-bailors, an outcome at odds with SIPA's purpose of customer protection.

The Trustee also has standing as the enforcer of SIPC's subrogation rights, which arise both under SIPA and under the common law. HSBC contends that allowing SIPC to sue third parties based upon its subrogation rights would upset SIPA's scheme for the allocation of customer property and improperly place SIPC ahead of customers. But HSBC misconstrues SIPA. SIPC can only share in

customer property as provided under SIPA. Any recovery by SIPC, as subrogee, constitutes customer property, and therefore must be turned over to the SIPA trustee under operative provisions of SIPA and the Bankruptcy Code. Where, as here, SIPC has assigned its subrogation rights to the Trustee, the matter is even simpler as there is no need for such a turn over, and any recovery by the Trustee automatically augments the fund of customer property.

ARGUMENT

I. AS THE BAILEE OF CUSTOMER PROPERTY, THE TRUSTEE HAS STANDING TO BRING HIS COMMON LAW CLAIMS

Since 1978, this Court, along with many of the lower courts in this jurisdiction, has held that a SIPA trustee has standing to sue a third party based on his rights as the bailee of customer property. See Redington v. Touche Ross & Co., 592 F.2d 617, 625 (2d Cir. 1978), rev'd on other grounds, 442 U.S. 560 (1979); SIPC v. BDO Seidman, LLC, 49 F.Supp.2d 644, 654 (S.D.N.Y. 1999), aff'd in part, question certified, 222 F.3d 63 (2d Cir. 2000), aff'd, 245 F.3d 174 (2d Cir. 2001); Picard v. Taylor (In re Park South Secs., LLC), 326 B.R. 505, 517 (Bankr. S.D.N.Y. 2005) (“Park South”); In re A.R. Baron & Co., 280 B.R. 794, 805 (Bankr. S.D.N.Y. 2002) (“A. R. Baron”). In Redington v. Touche Ross & Co., the Second Circuit stated explicitly that a SIPA trustee “is responsible for marshalling and returning [customer] property; to the extent that he is unable to do so . . . he may sue on behalf of the customer/bailors any wrongdoer whom they could sue

themselves.” 592 F.2d at 625. For the reasons discussed in detail below, Redington was correctly decided and remains good law in this jurisdiction.

A. Redington remains good law

1. Redington’s case history

Redington arose in the liquidation under SIPA of former SIPC-member Weis Securities, Inc. (“Weis”). The trustee for the liquidation and SIPC jointly commenced simultaneous actions against Touche Ross & Co. (“Touche Ross”), Weis’s former auditor, in both the New York Supreme Court and in the District Court. See Redington v. Touche Ross & Co., 428 F.Supp. 483, 486-88 (S.D.N.Y. 1977). In both actions, the trustee and SIPC asserted claims for negligence, malpractice, and breach of contract. Id. In their action in the District Court, the trustee and SIPC also asserted claims for violations of Section 17 of the Securities Exchange Act of 1934 (“1934 Act”), 15 U.S.C. § 78q, and Commission Rule 17a-5, 17 C.F.R. § 240.17a-5. Id. Touche Ross moved to dismiss the complaint filed in the District Court for lack of subject matter jurisdiction and for failure to state a claim, on the grounds, inter alia, that no private right of action existed under Section 17 of the 1934 Act and SEC Rule 17a-5, and that the District Court had no other basis for jurisdiction over the case. Id. at 488. The District Court granted that motion, holding that no private right of action existed under Section 17 of the

1934 Act and that it lacked “diversity” jurisdiction over the remaining common law claims brought by the trustee and SIPC. Id. at 491-93.

The trustee and SIPC appealed to this Court, which reversed the District Court decision. See Redington, 592 F.2d at 619, 625. This Court found that Weis’s customers had a private right of action under Section 17 of the 1934 Act, that SIPC had standing to bring a claim under that section as “subrogee of the customers whose claims it has paid,” and that the trustee had standing as the bailee of customer property. Id. at 623-24. By acknowledging that the trustee and SIPC had standing to pursue the action, it also acknowledged implicitly that they had standing to do so with respect to both their 1934 Act claims and their common law claims.

Touche Ross appealed the decision to the Supreme Court, which reversed that part of the this Court’s determination that Section 17 created a private right of action, but left undisturbed its holdings that SIPC had standing as the customers’ subrogee to pursue claims against third parties and that the SIPA trustee had standing as the bailee of customer property. The case was then remanded to this Court for further proceedings consistent with the Supreme Court’s decision. Touche Ross & Co. v. Redington, 442 U.S. 560 (1979).

On remand, this Court affirmed the District Court’s dismissal of the case for lack of subject matter jurisdiction, finding that: (i) it could not exercise “diversity”

jurisdiction as the parties were not of diverse citizenship, and (ii) in the absence of a claim arising under federal law, no alternative basis for jurisdiction existed. Redington v. Touche Ross & Co., 612 F.2d 68 (2d Cir. 1979). This Court did nothing to disturb its earlier ruling regarding standing of SIPC and the SIPA trustee, however. Id.

2. Redington and the law of jurisdiction and stare decisis

For several reasons, that ruling remains good law. In the first place, this Court had subject matter jurisdiction to render its standing ruling. Standing, whether constitutional or prudential, is a prerequisite to the exercise of subject matter jurisdiction. See, e.g., Elk Grove Unified School Dist. v. Newdow, 542 U.S. 1, 11 (2004) (discussing prudential standing); Carver v. City of NY, 621 F.3d 221, 225 (2d Cir. 2010), citing Warth v. Seldin, 422 U.S. 490, 498 (1975) (“[S]tanding is a federal jurisdictional question determining the power of the court to entertain the suit”); Cacchillo v. Insmmed, Inc., 638 F.3d 401, 404 (2d Cir. 2011); Lerner v. Fleet Bank, N.A., 318 F.3d 113, 127 (2d Cir. 2003) (“[P]rudential considerations of standing are also generally treated as jurisdictional in nature”); Thompson v. County of Franklin, 15 F.3d 245, 248 (2d Cir. 1994). Every court has both a right and an obligation to inquire into its jurisdiction, and may do so sua sponte at any time. See, e.g., City of New York v. Mickalis Pawn Shop, LLC, 645 F.3d 114, 125-26 (2d Cir. 2011). Moreover, a court’s inquiry into its jurisdiction

ordinarily should precede its analysis of the merits. See, e.g., Sinochem Int’l Co. v. Malaysia Int’l Shipping Corp., 549 U.S. 422, 431 (2007); City of New York, 645 F.3d at 126; Jennifer Matthew Nursing & Rehab. Ctr. v. U.S. Dep’t of Health & Human Servs., 607 F.3d 951, 955 (2d Cir. 2010). Finally, a federal court always has jurisdiction to determine whether it has jurisdiction, and any ruling resolving the question whether the court has jurisdiction is thus, by definition, supported by subject matter jurisdiction. See also United States v. Ruiz, 536 U.S. 622, 628 (2002) (“[I]t is familiar law that a federal court always has jurisdiction to determine its own jurisdiction”); In re Baldwin-United Corp. Litig., 765 F.2d 343, 347 (2d Cir. 1985).

Application of these principles to this Court’s standing decision in Redington is straightforward. The Court rendered that decision in order to resolve a challenge to the plaintiff’s standing; i.e., to resolve one aspect of the question whether the Court had subject matter jurisdiction over the suit. As the product of an inquiry into its jurisdiction, the Court’s Redington decision, by definition, was made with subject matter jurisdiction. See Ruiz, 536 U.S. at 628.

That decision remains controlling – or at least strongly persuasive and entitled to great weight - under the law of stare decisis. The published decision of a prior panel of this Court is binding upon a subsequent panel unless it is overruled by the Court en banc or by the Supreme Court. See, e.g., Baraket v. Holder, 632

F.3d 56, 59 (2d Cir. 2011) (citing S & R Co. of Kingston v. Latona Trucking, Inc., 159 F.3d 80, 83 (2d Cir. 1998), cert. dismissed, 528 U.S. 1058 (1999)). In fact, the prior panel’s decision remains binding precedent even if the prior panel “misinterpreted prior cases” or “was not required to decide[] the way that it did...” Id. (quoting S & R Co. of Kingston, 159 F.3d at 83.)

The controlling nature of prior precedent requires that a prior decision was a holding – i.e., necessary to resolution of the question before the court - and not dicta. See Baraket, 632 F.3d at 59; Jimenez v. Walker, 458 F.3d 130, 142-43(2d Cir. 2006) (citing Carroll v. Lessee of Carroll, 57 U.S. 275, 286-87 (1853) for the proposition that “[i]f [a point of law] might have been decided either way without affecting any right brought into question, then, according to the principles of the common law, an opinion on such a question is...” dicta), cert. den., 549 U.S. 1133 (2007). Even dicta may be entitled to great weight, however. In particular, judicial dicta, the product of comprehensive discussion by the Court on an issue briefed and argued by the parties, is of “great significance” and “must be given considerable weight and cannot be ignored in the resolution of [a] close question...” Boyd v. Henderson, 555 F.2d 56, 60 n. 5 (2d Cir. 1977), cert. den., 434 U.S. 927 (1977); United States v. Bell, 524 F.2d 202, 206 (2d Cir. 1975). See also Marc McAllister, Dicta Redefined, 47 Willamette L. Rev. 161, 167-68 (2011). In one context, this Court has analogized such dicta to “holdings from other

circuits.” See Wilkinson v. Russell, 182 F.3d 89, 113 (2d Cir. 1999), cert. den., 528 U.S. 1155 (2000). See also Ming Shi Xue v. Board of Immigration Appeals, 439 F.3d 111, 121 (2d Cir. 2006) (judicial dicta is “significant and worthy of respect”).

This Court opined on the status of the Redington decision in its 2000 decision in BDO Seidman. In the latter case, Judge (now Justice) Sotomayor, writing for the Court, explained that, had the Court needed to address in BDO Seidman the issue of the trustee’s standing as the bailee of customer property, it would have been bound to follow its prior decision in Redington, implicitly suggesting that the standing decision in Redington was holding, not dicta. See 222 F.3d at 69. In support, Judge Sotomayor cited this Court’s earlier decision in In re Sokolowski, 205 F.3d 532, 534-35 (2d Cir. 2000), for the proposition that “[t]his court is bound by a decision of a prior panel unless and until its rationale is overruled, implicitly or expressly, by the Supreme Court or this court *en banc*,” making her view of the Redington decision as holding even more explicit. Id. (emphasis added).

B. Redington was correctly decided

In any event, whether holding or dicta, Redington is correct. Specifically, the Redington court’s findings that a SIPA trustee is the bailee of the customer property entrusted to the liquidating firm, and that the trustee has standing to sue

third parties as bailee, were both correct statements of the law at the time Redington was decided, and remain correct today.

1. The Trustee is the bailee of customer property

A SIPA Trustee has the powers of a bailee of the Fund of Customer Property by virtue of: (1) SIPA; (2) Commission Rule 15c3-3 - known as the “customer protection rule”- as well as contractual agreements between the broker dealer and its customers that require the broker to hold property for its customers; and (3) applicable bailment law.

(a) Segregation requirements of Rule 15c3-3

Reinforcing contractual agreements that make the broker the custodian of its customer’s property, Rule 15c3-3 requires that a broker-dealer promptly obtain possession, and thereafter maintain physical possession or “control” of all “fully-paid” and “excess margin” securities held by the firm for customers. See 17 C.F.R. §§ 240.15c3-3(b)-(d). For this purpose, securities are deemed to be in the firm’s “control” when held in the firm’s name at a clearing corporation or other approved “control location” and allocated to the firm’s customers on its books and records – a form of “bookkeeping segregation.” See 17 C.F.R. § 240.15c3-3(c)(1) and (3). See also Michael E. Don & Josephine Wang, Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers, 12 Cardozo L. Rev. 508, 529-31 (1990) (“Don & Wang”). Most

important, the firm cannot use such securities in any aspect of its business, and thus cannot sell them without customer authorization, lend them to others, use them to deliver against short sales, or use them as collateral for a loan. See Steven D. Lofchie, Lofchie's Guide to Broker-Dealer Regulation 481 (3d ed. 2005) ("Lofchie").

Rule 15c3-3 treats customer cash slightly differently. Under the rule, and pursuant to a formula specified in Rule 15c3-3a, a broker-dealer must make a weekly calculation of an amount designed to reflect its net cash obligations to customers. See 17 C.F.R. §§ 240.15c3-3(e)(1), 240.15c3-3a. See also Michael P. Jamroz, The Customer Protection Rule, 57 Bus. Law. 1069, 1095-96 (2002) ("Jamroz"). The firm must then maintain in a "special reserve bank account for the exclusive benefit of customers" a deposit equal to the amount yielded by the Rule 15c3-3a calculation. See 17 C.F.R. § 240.15c3-3(e)(1). The firm at all times must keep this reserve account "separate from any other bank account of the broker or dealer" and must maintain a deposit in the account in the amount required by Rules 15c3-3 and 15c3-3a. See id.

The purpose of the reserve account requirement "is to ensure that funds a broker-dealer holds as a result of its customer business are used only to finance customer liabilities, and not to finance the broker's proprietary positions." Lofchie at 489. See also Jamroz at 1095-97. Thus, while Rule 15c3-3 recognizes that cash

is fungible, and therefore does not require a broker-dealer to segregate the specific cash deposited by its customers, it does require the broker-dealer to segregate cash in an amount equal to its current, net cash obligations to all customers. As in the case of securities, the rule thus requires the physical segregation of customer property on an aggregate basis. Should the firm have to liquidate, this cash is then available for delivery to individual customers in accordance with the firm's cash obligations to them, as established, through the firm's books and records – another instance of “bookkeeping segregation” comparable to the one applicable to customer securities. Cf., Jamroz at 1095-97.

(b) Origins of Rule 15c3-3

In order to understand how Rule 15c3-3 interacts with SIPA and federal common law to create a bailment relationship between the Trustee and customers, it is important trace the history of these provisions and their relationship to one another.

(i) Prior to 1938

Prior to 1938, when the number of brokers in the securities industry was limited and transaction volume was a small fraction of its current level, state law governed a brokerage customer's relationship with the customer's broker-dealer, and the states were divided in their treatment of that relationship. Under the majority rule, first developed in New York, a pledge relationship existed when the

broker bought securities for the customer on margin, while a customer who left securities with a broker for sale was a principal and the broker his or her agent. In all circumstances, under New York law, the customer was deemed to own the securities, whether those securities were fully-paid or bought on margin. In contrast, under the minority rule established in Massachusetts, the relation of broker and customer, at least with respect to securities bought on margin, was one of debtor and creditor. See 3 Collier on Bankruptcy, ¶¶60.71, 60.72 at 1157-1165 (14th ed. 1977) (“Collier”).

During this period, resolution of insolvent broker-dealers occurred under the Bankruptcy Act of 1898 (“Bankruptcy Act”), the predecessor of the modern Bankruptcy Code. Under the former Bankruptcy Act, customers were eligible to receive fully-paid securities left on deposit with a failed broker-dealer by means of a petition for reclamation. In order to prevail on a petition, a customer had to be able to trace his or securities into the hands of the debtor firm. Id. As a general proposition, if the customer could trace, the customer could reclaim. Where a customer could not trace, however, his or her only remedy was as a general creditor. Id. at 1161-1163.

The ability of a customer who could trace was limited by the availability of shares of the type claimed by the customer. Stock was viewed as fungible, and so long as the broker had in its possession sufficient shares of a particular security to

satisfy all customers claiming that security, each customer could recover in full without further identification. Where the broker possessed an insufficient number of shares to satisfy all customers, however, those customers would share in the available securities on a ratable basis. Id. at 1164. See Charles H. Meyer, The Law of Stockbrokers and Stock Exchanges 618-658 (1931).

(ii) 1938 - Section 60e of the Bankruptcy Act

As the foregoing suggests, the reclamation process in effect prior to 1938 produced uneven treatment of customers. Whether a customer could reclaim securities held in custody by a failed broker-dealer depended upon such factors as which state's law controlled the customer's relationship with the broker-dealer and whether the customer could trace his or her securities in the possession of that broker-dealer. The latter question was determined largely on the customer's luck, turning, for instance, on whether the broker-dealer retained possession of the customer's securities or disposed of them in some improper manner, e.g., through conversion.

In order to introduce a uniform system of distribution, and thereby eliminate the disparate treatment caused by the application of state law to the customers of failed securities broker-dealers, Congress enacted Section 60e to the Bankruptcy Act, as part of the Chandler Act. See 11 U.S.C. § 96e (repealed effective 1979) ("Section 60e"). Section 60e preserved some continuity with prior law, however,

in continuing to base customer recovery on bailment concepts. Thus, under the section, “cash customers” – those who had no debit balance in their accounts and who were entitled to immediate delivery of securities – could reclaim their “specifically identifiable property.” See Section 60e(1). That category encompassed securities received from or for a customer’s account that either “remained in its identical form in the stockbroker’s possession until the date of bankruptcy” or, within a specified time prior to the commencement of the bankruptcy, was “allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy.” See Section 60e(4). To the extent a customer could not meet the conditions necessary to establish claimed securities as “specifically identifiable property,” the customer shared pro rata with other such customers in a “single and separate fund,” a pool of property, excluding “specifically identifiable property,” consisting of securities “received, acquired, or held...from or for the account of customers...and the proceeds of all customers’ property rightfully transferred or unlawfully converted by the stockbroker.” See Section 60e(2). See also Collier, ¶60.73 at 1168- 1171.

Although Section 60e made substantial advances toward the equal treatment of customers, it gradually ceased to accord with the dominant custodial practices in the securities industry. In particular, as the industry grew, along with transactional volume, custody moved increasingly toward the “bulk segregation” of securities.

See Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, Pt. 1, at 413-14 (1963) (“SEC Report”). Under this system of custody, broker-dealers filed securities held for customers in alphabetical order in special boxes maintained in their vaults. They did not segregate those boxes, or the securities within them, by customer, and instead allocated those securities to their customers on collateral records – effecting what later became known as “bookkeeping segregation.” See SEC v. Albert & Maguire Sec. Co., 378 F. Supp. 906, 910 (E.D. Pa. 1974). See also Collier, ¶60.74 at 1187.

Bulk segregation was incompatible with the concept of “specifically identifiable property,” however, which, as noted, required that securities be held by a broker in the same form as received from the customer, or be allocated or physically set aside for the customer. See supra. As a result, most customers were ineligible to recover securities as “specifically identifiable property,” and instead were relegated to claims against the “single and separate fund.” See SEC Report at 413-14.

The treatment of customer cash during this period also created problems for customers. Broker-dealers were not required to, and typically did not, segregate customer cash, and instead generally commingled customer cash with broker-dealer funds and used the commingled funds as part of their working capital. See SEC Report at 413-14. Moreover, although Section 60e(4) expressly provided that

cash could qualify as “specifically identifiable property,” the definition of “cash customer” in Section 60e(3) made no reference to entitlement to “cash.” Accordingly, even where a broker-dealer segregated customer cash, there was no certainty that a customer claiming that cash was entitled to it under Section 60e. See SEC Report at 413-14.

(iii) 1970 - SIPA

SIPA was enacted on December 30, 1970, among other reasons, to rectify these deficiencies. While Congress retained many of the concepts used in Section 60e, Congress modified those concepts in significant ways.

In particular, through SIPA, Congress introduced three important changes to the key concepts in Section 60e. First, Congress made clear that customers entitled to immediate possession of cash qualified as “cash customers” entitled to “specifically identifiable property.” Second, Congress expanded the definition of “specifically identifiable property” to include property allocated to or physically set aside for customers on the SIPA “filing date,” instead of before the bankruptcy or while the broker was solvent, as under Section 60e(4). Third, Congress provided expressly that property would be deemed to have been “physically allocated or set aside for customers” – and thus would qualify as “specifically identifiable property” – if: (1) in the case of securities, the securities had been segregated, either individually or in bulk, for customers; (2) the records of the

liquidating broker-dealer showed, or the SIPA trustee was otherwise satisfied, that securities held for the broker-dealer's account at a clearing corporation or similar depository were, in fact, held for customers, and the securities positions allocable to those customers were identifiable; or (3) such property was deemed to be specifically identifiable by SEC Rule. See SIPA §§ 78fff(c)(2)(C)(i)-(iii) (1970).

Through SIPA, customers could recover the securities owed to them by a failed broker-dealer where those securities were held by the broker-dealer in a pool that included other customer securities, provided that the claimed securities were allocated to the customer on the broker's books and records. Congress thus adapted the concept of bailment that always had formed the basis of the customer-broker relationship – at least in the majority of states following the New York rule – to the practice of bulk segregation now prevalent in the securities industry.

Moreover, Congress anticipated that further modifications to the statute and custodial rules would be necessary as custodial practices in the securities industry evolved. In fact, Congress's intended purpose in giving the Commission rule-making authority was to enable it “to establish other types of custody which would constitute specific identification” and thereby “provide for future developments in the processing and custody of securities.” See H. R. Rep. No. 91-1613, at 10 (1970).

(iv) 1973 - Rule 15c3-3

As transactional volume in the securities industry continued to expand during the 1960s, bulk segregation of customer securities was no longer practical, and broker-dealers again began to adjust their custodial practices. Many brokers turned to a system authorized under the rules of the New York Stock Exchange which permitted the physical commingling of all securities, whether customer or firm, fully-paid, margin, or excess margin. The new system, called “one box,” recognized the fungibility of shares of the same security by permitting the broker to pledge, lend, or deliver any of the securities in its possession, provided that the broker retained a sufficient number of shares to satisfy all customers with fully-paid and excess margin securities held at the firm. Since the only means of linking particular securities to customers was via the broker’s records, the one box system effectively became “bookkeeping rather than physical segregation.” N. Wolfson, R. Phillips & T. Russo, Regulation of Brokers, Dealers and Securities Markets ¶7.02[1][a] at 7-6 – 7-7 (1977) (“Wolfson”).

As a result of this change, custodial practice in the securities industry was again incompatible with the definition of “specifically identifiable property” under SIPA, the same problem that had existed under Section 60e. In particular, because of the treatment of securities as fungible under the one box system, and the absence of any physical segregation of customer securities as part of that system, securities held for customers through that system could not be deemed to have been

“allocated or physically set aside for customers” within the meaning of SIPA’s definition of “specifically identifiable property.”

To rectify this problem, the SEC exercised its authority under SIPA section 78kkk(g), see supra, to promulgate Rule 15c3-3, which became effective on January 15, 1973. The rule provided, inter alia, that all fully paid and excess margin securities in the possession or control of the broker-dealer “shall constitute the specifically identifiable property of customers having claims for fully paid and excess margin securities as their interests may appear from the books or records of the broker or dealer...” See 17 C.F.R. § 240.15c3-3(j)(1) (1973). The rule thus brought customer securities held via the one box system within the definition of “specifically identifiable property,” and provided further legal support for the practice of “bookkeeping segregation.” See Exchange Act Release No. 9622, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,801 (May 31, 1972).

The SEC also extended that practice to cash for the first time. Prior to the adoption of Rule 15c3-3, there were few restrictions on a broker-dealer’s use of cash received from customers. See Jamroz at 1097-99. Although the Commission adopted Rule 15c3-2 in 1964 to address this problem, that rule required only that the broker-dealer periodically disclose to a customer that the broker might use the customer’s cash in the operation of the broker’s business and that the funds were payable on demand. See 17 C.F.R. § 15c3-2.

In contrast, Rule 15c3-3 for the first time required all broker-dealers, with limited exceptions, to maintain a reserve account at all times containing a deposit of cash or “qualified securities” in an amount equal to the broker-dealer’s net cash obligations to customers. See 17 C.F.R. § 240.15c3-3(e). Under the rule, the cash and “qualified securities”³ deposited with the broker-dealer were deemed to be the “specifically identifiable property of those customers of the broker or dealer who have free credit balances.”⁴ 17 C.F.R. §240.15c3-3(j)(2) (1973). Moreover, the broker-dealer was expressly precluded from using reserve account cash in its business, and instead was required to hold the account for the “exclusive benefit of customers.” Although the cash in the reserve account was segregated on an aggregate basis – with no distinction in the account itself between and among individual customers – the books and records of the broker-dealer, if maintained properly, supplied the information necessary to link specific amounts of cash in the account to specific customers. Thus, as in the case of securities, Rule 15c3-3 effectively mandated the “bookkeeping segregation” of customer cash.

(v) 1978 – Modifications to SIPA

³ Under SEC Rule 15c3-3(a)(6), “qualified securities” consist of securities issued or guaranteed by the United States Government. See 17 C.F.R. § 240.15c3-3(a)(6).

⁴ With certain exceptions not relevant here, “free credit balances” are “liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand.” 17 C.F.R. § 240.15c3-3(a)(8).

In 1978, Congress modified SIPA, with two principal objectives: (1) to achieve greater equality among customers; and (2) to cushion the blow to customers of a broker-dealer's failure by restoring the customer, as promptly as possible, to the position in which the customer would have been had the broker not failed. See S. Rep. No. 95-763, at 2 (1978), reprinted in 1978 U.S.C.C.A.N. 764, 765. Toward these ends, Congress replaced the concept of "specifically identifiable property" with "customer name securities" – a highly limited category consisting of only those securities either registered in the name of a customer or in the process of being so registered. See SIPA § 78lll(3). Under SIPA, as modified, such securities are returnable to the registrant customers outright. See SIPA § 78fff-2(c)(2).

Congress expanded the concept of the "single and separate fund" and renamed it the fund of "customer property." Customers share ratably in that Fund to the extent of their "net equities" – generally the difference between the aggregate value of the cash and securities owed by the broker to the customer, less the aggregate value of the customer's debts to the broker. See SIPA §§ 78fff-2(c)(1) and 78lll(4). Where a customer's share of customer property is insufficient to return all cash and securities owed to the customer, the customer is eligible for an additional distribution made from advances to the trustee by SIPC, within the limits of protection imposed by SIPA. See SIPA 78fff-3(a). Although SIPA has

been modified since 1978, none of these subsequent modifications is relevant to this action, and the critical provisions reviewed above remain intact.

Following the enactment of the 1978 amendments to SIPA, the SEC revised Rule 15c3-3 to reflect the statutory modifications. See Amendments to Conform to the Securities Investor Protection Act of 1970, 44 Fed. Reg. 1974, 1974-75 (Jan. 9, 1979). Importantly, however, neither Congress through SIPA, nor the Commission through Rule 15c3-3, in any way modified the segregation requirements previously imposed as part of the Rule. In fact, from the date of its adoption in January 1973, through the present, Rule 15c3-3 has retained the “bookkeeping segregation” requirements reviewed above regarding customer cash and securities. See 17 C.F.R. § 240.15c3-3(b)-(e).

(c) Relationship between Rule 15c3-3 and SIPA

Rule 15c3-3 and SIPA fit hand in glove. The “bookkeeping segregation” requirements in Rule 15c3-3, for example, are designed to ensure that, in the event of a broker-dealer failure, all cash and securities owed by a broker-dealer to its customers on a net basis are available for return to them. See Jamroz at 1071-74. Even partial compliance with the rule by a broker-dealer ensures that some customer property will be available for return to customers in a liquidation under SIPA. Id. As one commentator has explained:

[T]he primary purpose of the Customer Protection Rule is to ensure that customer property in a failed brokerage

firm is available to satisfy the claims of customers. The rule was adopted by the Commission in response to a mandate by Congress when it adopted section 7(d) of the Securities Investor Protection Act (SIPA)...

The Customer Protection Rule plays an integral role in assuring that customer property held by failed securities firms will be sufficient to satisfy customer claims in a self-liquidation or a proceeding under SIPA.

See Jamroz at 1071, 1073.

Moreover, when a SIPA liquidation begins, the SIPA trustee assumes all the same powers that the broker-dealer had under Rule 15c3-3 as the custodian (bailee) of customer property prior to the commencement of the liquidation. In this regard, as this Court noted in Redington, the trustee is obligated to marshal customer property and hold it in trust for customers. See Redington, 592 F.2d at 625. See also SIPA § 78fff(a)(1)(B) (“distribute customer property and ... otherwise satisfy net equity claims of customers to the extent provided in this section”); SIPA § 78fff(b) (providing for the application in SIPA liquidations of certain sections of the Bankruptcy Code, to the extent consistent with SIPA); SIPA § 78fff-1(a) and (b) (providing that a SIPA trustee generally has the powers and duties of a Chapter 7 trustee, but obligating the trustee to deliver securities “to the maximum extent practicable in satisfaction of customer claims”); 11 U.S.C. §§ 704(a)(1) (requiring trustee to collect property of the estate).

(d) Applicability of federal common law

For the reasons discussed, federal law governs the relationship between both BLMIS and its customers, and the relationship between those customers and the Trustee, and, to the extent necessary, the federal common law of bailment fills in any gaps in the statutory/regulatory scheme described above. The Redington decision hints at the applicability of federal common law in this context, citing, inter alia, the principles underlying Rule 17(a) of the Federal Rules of Civil Procedure as the source of a SIPA trustee's standing as bailee. See Redington, 592 F.2d at 625.

Moreover, under prevailing Supreme Court precedent, the application of federal common law is appropriate where, as here, there is a significant conflict between some federal policy or interest and the use of state law. See, e.g., Wallis v. Pan. Am. Petroleum Corp., 384 U.S. 63, 68 (1966). While the courts presume that state law is determinative where private parties have entered legal relationships with the expectation that their rights and obligations will be governed by state law standards, no such presumption exists where the rights of the parties are governed by federal law. Cf., Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 98 (1991); Marsh v. Rosenbloom, 499 F.3d 165, 181 (2d Cir. 2007). In determining whether to apply federal common law, the courts consider whether: (1) there is a "need for a nationally uniform body of law;" (2) application of state law would frustrate specific objectives of a federal program; and (3) "the extent to

which application of a federal rule would disrupt commercial relationships predicated on state law.” United States v. Kimbell Foods, Inc., 440 U.S. 715, 728-29 (1979).

Under these standards, it is clear that the federal common law of bailment governs the relationship between securities broker-dealers and their customers. Through Rule 15c3-3 and SIPA (and Section 60e of the Bankruptcy Act of 1898, SIPA’s predecessor), Congress and the Commission federalized that relationship. They did so in order to override inconsistencies in state law - e.g., a conflict between New York and Massachusetts law regarding the legal character to the customer-broker relationship – and to ensure national uniformity in the treatment of brokerage customers and the custody of their investment assets. See Don & Wang at 520-27. Allowing state law to assign a different character to that relationship would undercut the principal purpose of Rule 15c3-3 and one of the key objectives of SIPA and its predecessor statute.

Moreover, through Rule 15c3-3 and SIPA (and its predecessor, section 60e), and their emphasis on “bookkeeping segregation,” the Commission and Congress consciously adapted general principles of bailment law to custodial practices in the securities industry. In so doing, they attempted to preserve the traditional character of the relationship between brokers and their customers – that of bailment - without imposing custodial requirements that would interfere with efficiency in securities

trading and impede the further growth of the industry. Reverting to state bailment laws to define the relationship of the trustee and the customers is incompatible with that intent.

More importantly, it would undercut another of SIPA's key purposes – facilitating the recovery and distribution of customer property by the trustee. As noted, one of Congress's principal aims in enacting SIPA was to restore customers as quickly as possible to the status they would have occupied had the liquidating broker-dealer not failed. SIPA § 78fff(a)(1)(B). Toward that end, SIPA empowers trustees to marshal customer property for distribution to customers, as the Second Circuit noted in Redington. Allowing state law to re-characterize the relationship between a broker-dealer and its customers would produce inconsistencies in the power of the trustee, as bailee, to recover customer property. It would eliminate that power where, as HSBC contends is the case here, the custodial requirements imposed by Rule 15c3-3 are insufficient to create a bailment relationship under applicable state law. That is the opposite of what Congress intended when it enacted SIPA.

Finally, as the foregoing suggests, application of federal common law here would not disrupt any commercial relationship predicated on state law. As discussed, the custodial relationship between a brokerage customer and a securities broker-dealer is governed by federal law – specifically Commission Rule 15c3-3.

As a result, the parties to the brokerage contracts relevant here had no reason to expect that state law would govern that relationship under the circumstances presented, and there is no state law that would be displaced by the application of federal common law.

The bailment relationship between the Trustee and the customers derives from SEC Rule 15c3-3 and SIPA. Application of either federal common law or New York law results in the same standing of the Trustee as a bailee and the same power of the Trustee to sue to recover customer property.

(e) The Trustee as bailee under federal common law

Under federal common law, a bailment is created by the delivery of goods or personal property to the bailee in trust, under an express or implied contract, which requires the bailee to perform the trust and either to redeliver the bailed property or to dispose of it in accordance with the purpose of the trust. See, e.g., Thyssen Steel Co. v. M/V Kavo Yerakas, 50 F.3d 1349, 1354-55 (5th Cir. 1995); Ace American Ins. Co. v. First Choice Marine, Inc., 2010 WL 3125945, at ** 3-4 (M.D. Fla. July 29, 2010); McCutcheon v. Charleston Boatworks, Inc., 2010 WL 2431017, at * 4 (D.S.C. June 14, 2010) (where there is no federal common law addressing a particular issue, the court may look to general bailment law principles); Fireman's Fund Ins. Co. v. Panalpina, Inc., 153 F.Supp.2d 1339, 1343 (S.D. Fla. 2001). See also Richard A. Lord, 19 Williston on Contracts § 53:2 (4th ed. 2011) (“Williston”).

Further, where a bailment involves fungible property, like cash or securities, the bailee is not obligated to return the specific property received from the bailor, and may instead return an equivalent quantity of property of the same type. See, e.g., 19 Williston § 53:6.

Under these standards, there is no doubt that a bailment existed between BLMIS and its customers. Pursuant to account agreements entered into with BLMIS, innocent customers entrusted cash to BLMIS for the purpose of purchasing and holding securities for them, and believed that BLMIS had done so. The contracts, and Rule 15c3-3, required that BLMIS hold such cash and/or securities in “bookkeeping segregation” for the customers in the manner described, and that BLMIS return that property, or its equivalent, to the customers upon demand. Custody of this kind satisfies all of the criteria necessary to create a bailment relationship under federal common law. Prior to the commencement of the BLMIS liquidation, BLMIS therefore was the bailee of the property of its customers, and the Trustee succeeded to that role.

(f) The Trustee as bailee under New York law

Under the common law of New York, as under federal common law, a bailment is created by the “delivery of personal property for some particular purpose, or a mere deposit, upon a contract express or implied, and that after such purpose has been fulfilled it shall be redelivered to the person who delivered it, or

otherwise dealt with according to his directions or kept until he reclaims it, as the case may be.” Herrington v. Verrilli, 151 F.Supp.2d 449, 457 (S.D.N.Y. 2001). In the case of fungible property, New York generally permits the substitution of equivalent property in place of the property originally bailed. See, e.g., id. at 457. See also 8 C.J.S. Bailments § 100 (2011) (“C.J.S.”). Cf., Bank of New York v. Amoco Oil Co., 35 F.3d 643, 655 (2d Cir. 1994) (under New York’s U.C.C., identification of goods as part of fungible mass sufficient to create bailment). Thus, the relationship between BLMIS and its customers was one of bailment.

(g) The bailee’s intent is irrelevant

In the District Court, HSBC contended that no bailment relationship was formed between BLMIS and the customers because Madoff was a thief and intended to appropriate the bailed property at the time of receipt. But that contention was based upon a state law principle that is overridden by Rule 15c3-3 and SIPA. Rule 15c3-3 imposes the obligations of a bailee upon a broker-dealer who accepts custody of investor cash or securities irrespective of the broker’s intent with respect to that property. Likewise, and in keeping with Rule 15c3-3, SIPA’s definition of “customer property,” which is to be marshaled by the trustee and distributed to customers, encompasses cash or securities “unlawfully converted” by the broker-dealer, including such property converted at the inception of the customer-broker relationship. See SIPA §§78fff(a)(1)(B) and 78lll(4). Of

course, requiring innocent intent on the part of the bailee as a pre-requisite to the formation of a bailment relationship would utterly frustrate the primary objective of both Rule 15c3-3 and SIPA – namely, customer protection. Both the Rule and the statute thus override any state law requirement regarding the bailee’s intent that HSBC argues would apply.

(h) Ratable distribution is consistent with bailment

HSBC also contended in the District Court that the SIPA provisions requiring the ratable distribution of customer property to customers destroy any bailment that would otherwise exist between the Trustee and the customers. Generally, however, with the modifications discussed below, the Trustee merely inherits the broker’s prior bailment relationship with its customers and, as such, owes all cash and securities held in custody for them by the broker. See SIPA §78lll(2). See also Matter of Atkeison, 446 F.Supp. 844, 847 (M. D. Tenn. 1977) (SIPA protects customers “who have either cash or securities ... in the custody of broker-dealer firms”). The fact that SIPA permits interim pro rata distributions of customer property, as such property is amassed by the trustee, does not alter what the customer ultimately is owed, and certainly does not prevent the formation of a bailment relationship when the property in question is initially bailed.

Moreover, while SIPA allows pro rata distributions of customer property to customers, that distribution scheme is entirely consistent with the manner in which

bailment law has been applied where multiple bailors have bailed fungible property that is held in a common pool by a bailee, which then becomes insolvent. See, e.g., Rahilly v. Wilson, 20 F. Cas. 176, 176-77 (D. Minn. 1872), aff'd in part, 20 F.Cas. 179 (C.C.D. Minn. 1873) (bailment created where multiple producers of wheat stored the commingled product in warehouse, entitling the producer/bailors to pro rata share of wheat remaining in warehouse's custody upon its failure). See also Calumet Paper Co. v. Haskell Show-Printing Co., 45 S.W. 1115, 1116-17 (Mo. 1898) (assignee of property of insolvent corporation held property in bailment for corporation's creditors and was obligated to allocate it to those creditors on a pro rata basis); Donk Bros. Coal & Coke Co. v. Kinealy, 83 Mo. App. 40 (Mo. Ct. App. 1900) (same).

2. As bailee, the Trustee has a possessory interest in Customer Property

As the bailee of customer property, a SIPA trustee has a possessory interest in that property. See, e.g., Redington, 592 F.2d at 625. That principle is as firmly established in New York law as it is in the law of bailment generally. See, e.g., United States v. Perea, 986 F.2d 633, 640 (2d Cir. 1993) ("Perea"). See also 8 C.J.S. Bailments § 156.

In exercising possessory rights to recover bailed property from a third party, a SIPA trustee, as bailee, stands in the shoes of the customer-bailors. Redington, 592 F.2d at 625. In other words, the bailee has the same right of action as the

bailor even though the bailee sues to enforce its obligations as bailee. Again, that principle is grounded in long-established bailment law, both in New York and elsewhere. See, e.g., Perea, 986 F.2d at 640 (under New York law, bailee has the “right of the owner” to recover bailed property and consequential damages from misuse of that property); Paragon Oil Co. v. Republic Tankers, S.A., 310 F.2d 169, 175 (2d Cir. 1962) (noting that “the bailee is entitled to recover the full value of the [bailed] goods or the full value of the damage inflicted”), cert. den. sub nom., Yacimientos Petroliferos Fiscales v. Paragon Oil Co., 372 U.S. 967 (1963); 9 N.Y. Jur.2d Bailments and Chattel Leases § 91 (“N.Y. Jur.”). See also Baldwin v. Hill, 315 F.2d 738, 742 (6th Cir. 1963); United States v. Currency \$716,502.44, 2008 WL 5158291, at * 4 (E. D. Mich. Dec. 5, 2008) (“[A] bailee has agreed to hold the bailor’s property according to certain terms and obligations, and then stands in the place of the owner in his ability to assert claims against third parties”); King Grain Co. v. Caldwell Mfg. Co., 820 F.Supp. 569, 572 (D. Kans. 1993) (“King Grain”). The bailee holds any recovery from a third party in trust for the bailor. See, e. g., N.Y. Jur. at § 91.

3. Wagoner and Caplin do not bar the Trustee’s suit

In Caplin, the Supreme Court held that a bankruptcy trustee has no standing to sue third parties on behalf of the creditors of the bankruptcy estate, but may only assert claims held by the debtor itself. See Caplin v. Marine Midland Grace Trust

Co. of New York, 406 U.S. 416, 434 (1972). In reliance on Caplin, this Court in Wagoner held that, where the insiders of a corporate debtor participated with third parties in defrauding the corporation, a bankruptcy trustee for the debtor corporation lacks standing to sue those third parties on causes of action held by creditors of the bankruptcy estate. See Wagoner, 944 F.2d at 119-20. The Court then further held that, because the debtor’s “sole stockholder and decisionmaker” knew of, and participated in, the fraud on the debtor, the trustee for the debtor was barred from suing the complicit third parties under New York’s doctrine of in pari delicto. Id. at 120.

Caplin has no application here because the Trustee brings his common law claims to vindicate his possessory interest as bailee and as the only party with standing to recapture customer property (including converted property) for customers. As discussed below, Wagoner does not apply because its application would contravene the primary objective of Rule 15c3-3 and SIPA, namely the protection, and equal treatment, of customers.

The Supreme Court and this Court have long recognized that in pari delicto does not apply where its application would frustrate the goals and purposes of a federal statutory or regulatory scheme. See Pinter v. Dahl, 486 U.S. 622, 632-33 (1988); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310-19 (1985) (“Batemen”); Perma Life Mufflers, Inc. v. Int’l Parts Corp., 392 U.S. 134,

138-40 (1968), rev'd on other grounds, Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1968); Peltz v. SHB Commodities, Inc., 115 F.3d 1082, 1089 (2d Cir. 1997); Ross v. Bolton, 904 F.2d 819, 825 (2d Cir. 1990). In fact, in pari delicto only applies in the context of the federal securities laws where “preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.” Batemen, 472 U.S. at 310-11. See also Pinter, 486 U.S. at 632-33; Peltz, 115 F.3d at 1089; Ross, 904 F.2d at 825.

That is exactly what would occur in a SIPA liquidation if suit by a SIPA trustee as bailee is barred by the doctrine. Customer property constitutes property of a SIPA debtor’s bankruptcy estate. See SIPA § 78fff-2(c)(1) (referencing “customer property of the debtor” (emphasis added)); 11 U.S.C. § 541(a)(1) (property of the estate includes “all legal or equitable interests of the debtor in property...”). Further, SIPA requires that customer property be allocated and distributed to customers on a ratable basis. Accordingly, the customer-bailors cannot sue at present because any such suit would violate the automatic stay imposed by Section 362(a) of the Bankruptcy Code and any recovery by them outside of the BLMIS liquidation would disrupt SIPA’s scheme for the allocation and ratable distribution of customer property. See 11 U.S.C. § 362(a)(3) (barring any act to obtain possession of, or exercise control over, property of the estate).

Instead, the Trustee, as bailee, must bring suit. If, however, the Trustee is barred from bringing suit by the doctrine of in pari delicto, then the customer-bailors would have no remedy against third parties that played an active and indispensable role in enabling BLMIS to victimize them. That result would manifestly frustrate public policy and SIPA's primary goal of making customers whole, and the statutory and regulatory scheme embodied in SIPA and SEC Rule 15c3-3 for the protection of customer assets. It is not, and cannot be, the law. Cf., SIPA § 78lll(4) (defining "customer property" to include converted property); Murray v. McGraw (In re Bell & Beckwith), 821 F.2d 333, 337-38 (6th Cir. 1987) ("SIPA alters the rights of the parties in a way not contemplated by the U.C.C."); Tepper v. Chicester, 285 F.2d 309, 312 (9th Cir. 1960).

Moreover, independent of SIPA, in pari delicto should not, and has never been held to, apply to a bailee's suit against a third party. Any limitation on the bailee's ability to sue that is based upon the comparative fault of the bailee and the third party normally also binds the bailor. Thus, for example, some courts hold that a third party sued by a bailee for negligence in the handling of bailed property may assert the bailee's contributory negligence as a defense. See, e.g., 8A Am. Jur. 2d Bailments § 165; Fischer v. Int'l Ry. Co., 182 N.Y.S. 313, 313-15 (N.Y.Sup.Ct. 1920). This rule works no hardship upon the bailor, who can recover from the bailee that portion of the liability for which the bailee is at fault.

Here, in pari delicto would serve as a complete bar to recovery of bailed property. Ross, 904 F.2d at 824 (“Where both parties are *in delicto*, but not *in pari delicto*, a trial court should make findings regarding the respective amount of blame assigned to each, granting relief to the one whose wrong is less”). If the bailor is bound by that bar, an innocent bailor would then be precluded from realizing any recovery against a culpable third party solely because of the misconduct of the bailee or its successor. If the bailee were insolvent or otherwise judgment proof, the bailor would realize no recovery, while both the bailee and the culpable party would escape liability for their misconduct. Otherwise stated, because the customers’ only means of recovery of their property is through the SIPA proceeding, in pari delicto would mean no recovery by customers of their property in this case, notwithstanding that “customer” property in which customers are to share, includes converted property. SIPA § 78lll(4).

4. The Trustee’s standing to sue is not limited by SIPA

In the District Court, HSBC contended that SIPA Section 78fff-1(a) limits a SIPA trustee’s standing to claims brought under the avoidance provisions of the Bankruptcy Code. See 11 U.S.C. §§ 544, 547-48. That section does no such thing.

Section 78fff-1(a) vests a SIPA trustee with “[t]he same powers and title with respect to the debtor and the property of the debtor, including the same rights to avoid preferences, as a trustee in a case under title 11.” See SIPA § 78fff-1(a).

Nothing in the section indicates that the trustee is limited to the powers of a Chapter 7 trustee, however, and to so read the statute would ignore the larger statutory context in which the section appears, in violation of the most elementary principles of statutory construction. See, e.g., Norman J. Singer, J.D. Shambie Singer, 2A Statutes and Statutory Construction § 47:6 (7th ed. 2007) (to the extent possible, all parts of a statute must be construed to harmonize with one another and with the purposes and objectives of the legislation).

As noted, SIPA requires a SIPA trustee to determine claims for “customer property,” and to marshal, allocate, and distribute such property in satisfaction of allowed claims. It strains credulity to suppose that Congress would impose such a duty on a SIPA trustee, while simultaneously withdrawing or restricting the trustee’s means for doing so. In fact, as discussed above, Congress intended the opposite. Thus, read properly and in context, Section 78fff-1(a) of SIPA merely confirms that, in addition to the other unique powers that the trustee has under SIPA, he or she also has those powers available to a bankruptcy trustee.

In any event, even if a SIPA trustee were limited to the powers available to a Title 11 trustee, the Trustee here still would have standing as bailee. Unlike securities broker-dealers, most businesses do not hold bailed property, and most debtors therefore do not qualify as bailees. In the rare case where a debtor is a bailee of property, however, the law of bailment would apply to the trustee for the

debtor's bankruptcy in exactly the same way that it applies to other bailees. In short, for the same reasons discussed above, the bankruptcy trustee, as bailee, would have standing to sue third parties for recovery of bailed property and disturbance of the debtor's possessory interest in the property, and would not be limited by the doctrine of in pari delicto as part of any such suit.

II. THE TRUSTEE HAS STANDING AS THE ENFORCER OF SIPC'S SUBROGATION RIGHTS

Beyond his standing as the bailee of customer property, the Trustee has standing to bring his common law claims as the enforcer of SIPC's subrogation rights. SIPA provides expressly, in pertinent part, that "to the extent moneys are advanced by SIPC to the trustee to pay or otherwise satisfy the claims of customers, in addition to all other rights it may have at law or in equity, SIPC shall be subrogated to the claims of such customers..." SIPA § 78fff-3(a). Consistent with the language, the three circuits that have considered the scope of this provision have all concluded that SIPC is subrogated to customer rights not only against the fund of customer property, but also against third parties. See Appleton v. First Nat'l Bank of Ohio, 62 F.3d 791, 799-800 (6th Cir. 1995); SIPC v. Vigman, 803 F.2d 1513, 1516 (9th Cir. 1986); SEC v. Albert & Maguire Secs. Co., Inc., 560 F.2d 569, 574 (3d Cir. 1977) ("[U]pon payment of a customer, SIPC becomes subrogated to the customer's rights against third parties").

In the District Court, HSBC challenged the Trustee's assertion of standing as the enforcer of SIPC's subrogation rights under the misguided belief that SIPC thereby would recover customer property ahead of customers, and such standing would be inconsistent with this Court's decision in Redington. Neither challenge has any merit.

As recognized in In re Bell & Beckwith, 937 F.2d 1104, 1108 (6th Cir. 1991), SIPA both allows and requires SIPC to share with customers in the allocation and distribution of customer property, but only to the extent of its advances for customers whose claims have been fully satisfied. Such participation by SIPC is completely consistent with SIPA's scheme for the allocation of customer property. That property is part of the debtor's bankruptcy estate under the operative provisions of SIPA and the Bankruptcy Code (11 U.S.C.). See SIPA § 78fff(b); 11 U.S.C. § 541(a). Accordingly, SIPC is barred by the automatic stay from bringing an action to recover such property and, even in the absence of the stay, would be obliged to turn any recovery of such property over to the SIPA trustee under the Bankruptcy Code. See 11 U.S.C. §§ 362(a), 542. Thus, under applicable law, SIPC, as subrogee, would not be able to recover except as prescribed under SIPA. Where, as here, SIPC has assigned its subrogation rights to the Trustee, the issue cannot even arise, as any customer property recovered by the Trustee through the exercise of SIPC's subrogation rights will automatically be

included in the Fund of Customer Property available for distribution to all customers. See SIPA § 78fff-2(c)(1); and Appleton, 62 F.3d at 800.

Redington imposed no limitation on SIPC's subrogation rights. In Redington, this Court merely stated that SIPA does not displace SIPC's state-law subrogation rights against third parties. The Court did not reach the issue whether the statute itself creates such rights. See Redington, 592 F.2d at 624. As noted, however, several other courts of appeals that reached that issue concluded that SIPA does create subrogation rights in SIPC independent of the common law. See, e.g., Appleton, 62 F.3d at 799-800; Vigman, 803 F.2d at 1516.

It is now even clearer, post-Redington, that SIPC's subrogation rights extend to suits against third parties. In 1978, Congress amended SIPA's subrogation provision to emphasize that the subrogation rights conferred upon SIPC are "in addition to all other rights it may have at law or in equity." See Appleton, 62 F.3d at 799. That addition confirms without doubt that SIPC enjoys common law subrogation rights against third parties under applicable state law. Id.

III. THE DISTRICT COURT'S STANDING DECISION IS ERRONEOUS

The District Court erred in dismissing the Trustee's common law claims for lack of standing. In the first instance, the Court erred in finding that SIPA Section 78fff-1(a) limits the Trustee to the powers available to a bankruptcy trustee. Even if correct, however, that finding would have no impact on the Trustee's standing as

bailee. As discussed, a SIPA trustee succeeds to a bailment relationship between a securities customer and a liquidating broker-dealer. That relationship arises at the time the customer entrusts cash or securities to the broker-dealer, i.e., before the liquidation commences. Thus, contrary to the District Court's finding, the misconduct alleged by the Trustee here – which caused a breach of bailment - occurred after, not before, the bailment arose. Further, BLMIS's intent when it received customer property – whether nefarious or noble – cannot have prevented the formation of a bailment relationship, since Rule 15c3-3 imposed the obligations of a bailee upon BLMIS irrespective of its intent. Likewise, the Trustee's obligation under SIPA to distribute recovered property ratably is identical to the common law of bailment.

The District Court's suggestion that the Trustee, as bailee, suffered no damages because the bailed property experienced a gain, not a loss, due to the actions of any of the parties reflects a misunderstanding of which property was bailed. The bailed property consists of the cash entrusted by the customer-bailors to BLMIS, not the fictional cash and securities positions fraudulently reported to the customers by BLMIS. The bailed customer cash did not change in value. BLMIS's misappropriation of that bailed cash, however - which both Appellees aided and abetted – did cause substantial consequential damages, for which the

Trustee now sues, along with restitution of the bailed cash received (or its equivalent).

In rejecting SIPC's subrogation rights as a source of standing, the Court cited Section 78fff-4(c) of SIPA. But that provision applies only in a "Direct Payment Procedure," an out-of-court procedure that may be used as a substitute for a court-administered liquidation only in cases where customer claims aggregate less than \$250,000. See SIPA § 78fff-4(a)(4). Moreover, the language in Section 78fff-4(c) limiting SIPC's subrogation rights to claims against the liquidating SIPC member is absent from Section 78fff-3(a), the subrogation provision applicable here, suggesting that Congress intended that no such limitation apply in the context of such a proceeding.

Further, as discussed, the use of SIPC's subrogation rights as the basis for suit against third parties could not subvert SIPA's order of priority for the allocation of "customer property" because SIPC could not assert those rights to seek recovery of customer property outside of SIPA. Any attempt to do so would violate the automatic stay imposed by Bankruptcy Code Section 362(a)(3), and, even in the absence of such a stay, SIPC would have to turn over any recovery to the Trustee under Code Section 542(a). In this light, the fact that Section 78fff-3(a) precludes SIPC's recovery against the Fund of Customer Property until after the allocation of that property to customers is perfectly consistent with SIPC's

right to sue third parties. After all, any recovery by SIPC pursuant to its subrogation rights would be a recovery of customer property, and would thus be allocable to customers on a ratable basis. Section 78fff-3(a) thus merely confirms that SIPC has no claim to customer property recovered through the exercise of its subrogation rights until that property has first been allocated to customers.⁵

The District Court's rejection of this Court's decision in Redington on the ground that the case was ultimately dismissed for lack of subject matter jurisdiction misses a key point. Because standing is a jurisdictional prerequisite to adjudication, this Court's standing decision in Redington was a jurisdictional determination. As noted, a court always has jurisdiction to decide whether it has jurisdiction, and this Court thus had jurisdiction to issue its standing decision. The principle that a decision entered without jurisdiction has no precedential value thus has no application to Redington, which remains good law.

The principle articulated in Nat'l R.R. Passenger Corp. v. Nat'l Ass'n. of R.R. Passengers, 414 U.S. 453 (1974), and relied upon by the District Court, that standing is not a threshold issue where there is doubt about the existence of a cause of action, has no application here. Statutory standing of the kind at issue in National Railroad, where the questions whether a cause of action exists under a

⁵ The Trustee is not presently pursuing his common law claims here as the assignee of customers, and the District Court's discussion of the Trustee's standing as assignee is therefore dicta.

statute and whether the plaintiff has standing under the statute are completely intertwined, is entirely distinct from prudential standing questions like those at issue. While statutory standing is a merits issue, prudential standing is a jurisdictional issue, which the court must resolve before proceeding to the merits. See, e.g., Steel Co. v. Citizens for a Better Environment, 523 U.S. 83, 92-103 (1998).

Finally, the District Court's invocation of the in pari delicto doctrine as a bar to the Trustee's common law claims was a mistake. For the reasons discussed above, the doctrine does not apply to suits brought by a SIPA trustee as bailee.

IV. SLUSA DOES NOT PREEMPT THE TRUSTEE'S CLAIMS

Although the District Court did not reach the question, HSBC also contended in the court below that SLUSA bars the Trustee's common law claims. Congress enacted SLUSA as part of the Private Securities Litigation Reform Act of 1995 in order to prevent securities class action plaintiffs from suing under state law so as to circumvent the stringent pleading requirements imposed on claims brought under the federal securities laws. See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 82 (2006); Anwar v. Fairfield Greenwich Ltd., 728 F.Supp.2d 372, 398 (S.D.N.Y. 2010). Under SLUSA, claims that: (1) are brought by a private party in a "covered class action;" (2) are based upon state or local law; (3) allege the misrepresentation or omission of a material fact "in

connection with” the purchase or sale of (4) a “covered security,” are preempted by SLUSA and subject to dismissal. See, e.g., Romano v. Kazacos, 609 F.3d 512, 517-18 (2d Cir. 2010). For the reasons discussed below, the instant cases do not constitute “covered class actions” and do not allege fraud “in connection with” the purchase or sale of a “covered security.”

A. The Trustee’s Amended Complaint Is Not A “Covered Class Action”

SLUSA defines a “covered class action” to include a single lawsuit in which “damages are sought on behalf of more than 50 persons or prospective class members...” and in which “questions of law or fact common to those persons...predominate.” See 15 U.S.C. §§77p(f)(2)(A)(i)(I); 78bb(f)(5)(B)(i)(I). SLUSA further provides that, in counting putative class members, an entity “shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action.” See 15 U.S.C. §§77p(f)(2)(C); 78bb(f)(5)(D). As this language indicates, unless an entity, including a trusteeship, is established for the purpose of bringing the claims in question, the Court cannot “look through” that entity to those who might benefit from its action, and instead must treat the entity as a single person in counting putative class members for purposes of the “covered class action” provisions. Id.

As the legislative history to SLUSA makes clear, Congress enacted this “entity exception,” inter alia, to ensure that a trustee, among others, would be able

to sue third parties to recover property of the estate. See, e.g., S. Rep. No. 105-182, at 8 (1998). In accord with the plain language of the entity exception, the lower courts in this jurisdiction, and courts elsewhere, have long held that the “primary purpose” for which an entity was created controls how it is treated. If that “primary purpose” was to bring the claims in question, then the courts apply a “look through” rule and consider the number of entity beneficiaries in counting the number of putative class members for purposes of the “covered class action” provisions. See, e.g., LaSala v. Lloyd’s TSB Bank, PLC, 514 F.Supp.2d 447, 470-71 (S.D.N.Y. 2007) (“TSB Bank”); LaSala v. UBS AG, 510 F.Supp.2d 213, 236-37 (S.D.N.Y. 2007); LaSala v. Bank of Cypress Public Co. Limited, 510 F.Supp.2d 246, 269-70 (S.D.N.Y. 2007) (“Cypress”); Lee v. Marsh & McLennan Companies, 2007 WL 704033, at * 4 (S.D.N.Y. Mar. 7, 2007) (“Lee”). See also LaSala v. Bordier Et Cie, 555 U.S. 1028, 132-33 (3d Cir. 2008), cert. dismissed, 555 U.S. 1028 (2008); Smith v. Arthur Andersen LLP, 421 F.3d 989, 1007-08 (9th Cir. 2005). In contrast, however, where the entity was not primarily created for the purpose of pursuing the challenged litigation, the “look through” rule is not applied, the entity is treated as a single person, and the number of ultimate beneficiaries is of no import.

The Trustee here was not appointed for the primary purpose of bringing and prosecuting his claims in this proceeding. Instead, as a matter of law, he has a host

of duties associated with the administration of the BLMIS estate, including, inter alia, administering all aspects of the claims process in the BLMIS liquidation, serving as bailee of customer property of the debtor, marshaling and distributing such property and other property of the debtor's estate, and investigating the failure of BLMIS. See SIPA §78fff-1(a) and (b); 11 U.S.C. § 704. Specifically, he generally has the same powers and duties as a Chapter 7 trustee, with modifications specified in SIPA. See SIPA §78fff-1(a) and (b). Accordingly, under the plain language of SLUSA, and the case law in this jurisdiction and elsewhere, the Trustee is a single person for purposes of counting putative class members and no "look-through" provision should be applied in making that computation. See 15 U.S.C. §§ 77p(f)(2)(C); 78bb(f)(5)(D); TSB Bank, 514 F.Supp.2d at 470-71; UBS AG, 510 F.Supp.2d at 236-37; Cypress, 510 F.Supp.2d at 269-70; Lee, 2007 WL 704033, at * 4; RGH Liquidating Trust v. Deloitte & Touche LLP, 955 N.E.2d 329 (N.Y. 2011). See also Bordier, 519 F.3d at 132-33. The number of customers and/or other estate creditors who may benefit from a recovery by the Trustee thus is not pertinent here, and the Trustee's claims in this proceeding therefore cannot form part of a "covered class action." Lee, 2007 WL 704033, at * 4.

The related limitation on the scope of the term "covered class action" noted above – the requirement that questions of law or fact common to putative class

members predominate – is also relevant here. As the plain language of this limitation suggests, where suit is brought by a trustee or other trust or estate representative, questions of law or fact must be common to more than 50 of the trust or estate beneficiaries in order to satisfy the numerical requirement imposed in the definition of the term. See Bordier, 519 F.3d at 133 (“The definition [of ‘covered class action’] is two-pronged: to be a covered class action, (1) the claim must be brought ‘on behalf of 50 or more persons,’ and (2) questions of law or fact common to ‘*those persons*’ must predominate” (emphasis in original)).

In this case, the only facts in dispute concern the knowledge and actions of HSBC, including whether those parties knew or should have known about the fraud at BLMIS, what actions they took, if any, that assisted the fraud. These are not questions of fact that relate to the affected BLMIS customers. As a result, under SLUSA’s plain language, even if the customers somehow constitute putative class members, the number of customers affected by the conduct of HSBC is irrelevant, and, again, the Trustee’s claims in this proceeding cannot qualify as a “covered class action.” See 15 U.S.C. §§ 77p(f)(2)(A)(i)(I); 78bb(f)(5)(B)(i)(I); Bordier, 519 F.3d at 132-33.

B. The Trustee has not alleged securities fraud

Finally, SLUSA does not apply here because the Trustee has not alleged fraud “in connection with” the purchase or sale of a “covered security” within the

meaning of SLUSA. As the lower courts have routinely found, SLUSA preempts only those claims for which allegations of “material misstatements or omissions” with respect to a “covered security” are necessary. See, e.g., Anwar, 728 F.Supp.2d at 399 n.7; Xpedior Creditor Trust v. Credit Suisse First Boston (USA) Inc., 341 F.Supp.2d 258, 266-70 (S.D.N.Y. 2004). Moreover, the alleged misstatements or omissions must be the focus of the plaintiff’s claim in order to trigger preemption. See, e.g., Pension Committee of the University of Montreal Pension Plan v. Banc of America Secs., LLC, 750 F.Supp.2d 450, 453-56 (S.D.N.Y. 2010) (investment in hedge fund shares does not trigger SLUSA preemption, even when the funds themselves invest in covered securities); In re Banco Santander Secs. - Optimal Litig., 732 F.Supp.2d 1305, 1317-18, 1341 (S.D. Fla. 2010) (finding no SLUSA preemption where Madoff’s fraud was not “the crux of this litigation”), aff’d sub nom., Inversiones Mar Octava Limitada v. Banco Santander S.A., 439 Fed. Appx. 840 (11th Cir. 2011).

The Trustee has made no allegations of material misstatements or omissions in connection with the purchase or sales of covered securities, and need not do so in order to sustain his claims. Further, the crux of his claims does not concern any such misstatements or omissions. Rather, the Trustee alleges, at most, that HSBC perpetuated the BLMIS fraud, inter alia, by helping to funnel additional investor cash into the BLMIS Ponzi scheme. Instead, the focus of the Trustee’s claims lies

several steps removed from Madoff's securities fraud, which is merely background to the Amended Complaint, and there is therefore no doubt that the Trustee's claims fall outside the scope of SLUSA.

CONCLUSION

For the reasons stated, this Court should reverse the District Court's judgment, reinstate the Trustee's common law claims, and remand this case to the Bankruptcy Court for further proceedings consistent with that decision.

Dated: Washington, D.C.
February 16, 2012

Respectfully submitted,

SECURITIES INVESTOR PROTECTION
CORPORATION

/s/ Josephine Wang
JOSEPHINE WANG
General Counsel

KEVIN H. BELL
Senior Associate General Counsel –
Dispute Resolution

CHRISTOPHER H. LAROSA
Senior Associate General Counsel – Litigation

805 15th Street, N.W., Suite 800
Washington, D.C. 20005
Telephone: (202) 371-8300

CERTIFICATE OF COMPLIANCE WITH RULE 32(a)

This brief complies with Fed. R. App. P. 32(a)(7)(B) because the brief contains 13,853 words, excluding the parts 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: Washington, D.C.
February 16, 2012

Respectfully submitted,

SECURITIES INVESTOR PROTECTION
CORPORATION

/s/ Josephine Wang
JOSEPHINE WANG
General Counsel

KEVIN H. BELL
Senior Associate General Counsel –
Dispute Resolution

CHRISTOPHER H. LAROSA
Senior Associate General Counsel – Litigation

805 15th Street, N.W., Suite 800
Washington, D.C. 20005
Telephone: (202) 371-8300