No. 11-969

IN THE

Supreme Court of the United States

THERESA ROSE RYAN, *et al.*,
Petitioners,

v.

IRVING H. PICARD, TRUSTEE,
Respondent.

On Petition For a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF THE SECURITIES INVESTOR PROTECTION CORPORATION IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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COUNTERSTATEMENT OF THE QUESTION PRESENTED

The trustee of a securities broker-dealer in liquidation under the Securities Investor Protection Act, 15 U.S.C. §78aaa et seq. ("SIPA"), satisfies the obligations of the broker-dealer to its customers "insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee." The broker-dealer in this case issued to its customers fictitious account statements that showed fictitious securities trades at fictitious prices invented by the broker-dealer to yield fictitious "profits." The petitioners rely upon the fictitious account statements in claiming that they are owed the fictitious amounts shown on the fictitious statements. Any such amounts previously paid to them actually were funds deposited with the broker-dealer by other investors and not the product of real trades. Under these circumstances, where the books and records of the debtor show that "profits" were fictitious, and where honoring the fictitious account statements perpetuates the broker-dealer's fraudulent scheme by continuing the practice of using some investors' money to benefit others, the question presented is whether the Court of Appeals erred in disregarding the fictitious account statements and in affirming the lower court's decision that customers in the liquidation proceeding are owed the net amount of their deposits with the broker-dealer and not fictitious profit.

CORPORATE DISCLOSURE STATEMENT

The Securities Investor Protection Corporation ("SIPC") is a federally chartered corporation under the Securities Investor Protection Act, 15 U.S.C. §78aaa et seq. SIPC has no parent and there is no publicly held company that owns 10% or more of stock in it.

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BRIEF OF THE SECURITIES INVESTOR PROTECTION CORPORATION IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

RELEVANT STATUTORY PROVISIONS

In addition to 15 U.S.C. §78lll(11), set out in the petition, the following statutory provision is relevant.

15 U.S.C. §78fff-2(b):

In relevant part, 15 U.S.C. §78fff-2(b) (2008)

provides:

> **(b) PAYMENTS TO CUSTOMERS**
>
> After receipt of a written statement of claim ***, the trustee shall promptly discharge, in accordance with the provisions of this section, all obligations of the debtor to a customer relating to, or net equity claims based upon, securities or cash, by the delivery of securities or the making of payments to or for the account of such customer *** insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee.

COUNTERSTATEMENT OF THE CASE

A. Commencement of the Liquidation Proceeding

On December 15, 2008, upon an application by the Securities Investor Protection Corporation ("SIPC"),[1] the United States District Court for the Southern District of New York ("District Court") entered an order placing Bernard L. Madoff Investment Securities LLC ("BLMIS" or "Debtor") in liquidation under SIPA and appointing Irving H.

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[1] 15 U.S.C. section 78eee(d) makes SIPC a party in interest as to all matters in a SIPA proceeding, "with the right to be heard on all such matters…."

For convenience, references hereinafter to provisions of SIPA shall omit "15 U.S.C."

Picard as trustee for the liquidation of the firm ("Trustee"). Consistent with SIPA section 78eee(b)(4), the District Court removed the case to the Bankruptcy Court for that District ("Bankruptcy Court").

Pursuant to SIPA section 78fff-2(a)(1), the Trustee caused notice of the liquidation proceeding to be published and mailed claim forms to "customers" and other creditors of the Debtor. Upon his review of "customer" claims received, the Trustee issued written determinations notifying the claimants whether their claims had been allowed or denied and informing them of their right to seek judicial review if they disagreed with a determination. As to each "customer" claim, the Trustee's determination contained his calculation of the claimant's "net equity." Net equity is the net amount owed to the customer by the broker-dealer under SIPA section 78lll(11).

B. The BLMIS Fraud

An investigation by the Trustee of BLMIS had revealed that BLMIS and Bernard L. Madoff ("Madoff"), its principal, ran a Ponzi scheme, and that BLMIS had issued fictitious account statements to customers, showing trades that never occurred, at backdated prices that were selected by Madoff to create fictitious returns that Madoff wanted investors to receive. Details of the fraud were confirmed by Frank DiPascali, Jr., a chief Madoff lieutenant, in his guilty plea to a criminal complaint. In relevant part, the complaint provided:

11. On a regular basis, Madoff provided guidance to [DiPascali], and, through [DiPascali], to other co-conspirators, about the gains or losses that Madoff wanted to be reflected in the account statements of the … Clients. Based on that guidance, [DiPascali] and other co-conspirators prepared model baskets of S&P 100 stocks based on historical market prices and tracked how those hypothetical baskets would have performed in the actual marketplace to determine whether and when to "enter the market." Whenever Madoff informed [DiPascali] that he had decided to "enter the market," [DiPascali] and other co-conspirators caused BLMIS computer operators to enter the data related to the chosen basket of securities into the computer that maintained the books and records of the … business. * * * *

When Madoff made a final decision to "enter the market," [DiPascali] and other co-conspirators would cause the computer to produce tens of thousands of false documents that purported to confirm the purchases of securities that in fact had not been purchased.

12. The purported trades by which BLMIS supposedly "entered the

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

Information filed on August 11, 2009, at 6-7, United States v. Frank DiPascali, Jr., No. 1:09-cr-00764-RJS-1 (S.D.N.Y.), available at www.justice.gov/usao/nys/madoff/20090811dipascaliinformationsigned.pdf. As Mr. DiPascali testified in his criminal case:

> On a regular basis I used hindsight to file historical prices on stocks then I used those prices to post purchase of sales to customer accounts as if they had been executed in realtime. On a regular basis I added fictitious trade data to account statements of certain clients to reflect the specific rate of earn return that Bernie Madoff had directed for that client.

Plea Hearing Transcript at 47, United States v. DiPascali, No. 09 Cr. 764 (S.D.N.Y. Aug. 11, 2009), available at http://www.justice.gov/usao/nys/madoff/dipascaliplea81109.pdf.

Because actual trades did not occur, investors who withdrew funds from their accounts received moneys deposited by other investors. Even if the investor did not immediately withdraw the fictitious profit, he benefitted from the fraud. Thus, the fictitious account statements showed that an investor's fictitious profits would be used to "buy" other "securities" for the investor resulting in fictitious securities positions in his account for which the investor never paid.

C. The Treatment of Fictitious Profit

In 2004, the Second Circuit had issued a decision in a SIPA case in which the Court held that customers would have claims for securities if they reasonably believed that securities had been purchased for them even if the securities had not actually been bought. A claim for securities would entitle the customer to up to $500,000 of protection from SIPC instead of $100,000, the limit of protection if a customer was owed cash. The Court also held, however, that where the "investment" and the account statements were fictitious, the customer's net equity would be the amount of cash deposited by the customer with the broker-dealer. Thus, the customer would be eligible for up to $500,000 of SIPA protection, and would receive back the net amount of his cash deposited with the broker, with no "customer" claim to bogus interest

or dividend reinvestments. In re New Times Securities Services, Inc., 371 F.3d 68, 88 (2d Cir. 2004) ("New Times I").

The Trustee in the BLMIS case determined customers' "net equity," including that of the petitioners, consistent with the law of the Circuit. The customer's net equity would be the net amount of cash deposited by the customer with the brokerage. Net equity would not include the fictitious profits invented by Madoff and customers would not be entitled to them.

The petitioners and others objected to the Trustee's determination of their "customer" claims. In adjudicating the objections, the Bankruptcy Court agreed with the Trustee's method of calculating net equity, as did the Second Circuit in the expedited appeal that followed.

The petitioners now seek review by this Court, asking the Court to give effect to the fictitious account statements which, if allowed, will perpetuate the Madoff fraud and benefit the petitioners.

SIPC respectfully submits that the Court should deny the petition.

ARGUMENT

The petitioners contend that giving effect to the fictitious statements will reinforce investor confidence in the marketplace. In fact, the opposite is true. Adoption of their position undermines a fundamental and sacred principle of a free market –

the determination of market price by supply and demand, and not by manipulation. More immediately, in this case, giving effect to the fictitious account statements and the fictitious prices harms those already most aggrieved by Madoff's actions: investors who did not withdraw any or all of their funds from the brokerage and whose funds therefore were used to pay fictitious profit to other investors. In the parlance of the BLMIS case, the latter investors are "net losers." They stand in contrast to the investors who took out more from their accounts than they deposited and therefore, received fictitious profits. They are the "net winners."

In order to understand how and why the net losers are harmed by the petitioners' approach, it is useful to consider preliminarily the nature of SIPA protection and the order of distribution of assets in a SIPA case.

I. OVERVIEW OF SIPA

A. SIPC and Customer Status

Notwithstanding the petitioners' repeated mischaracterization of it, the Second Circuit properly found that SIPC protection is not "insurance," and SIPC is not an insurer. Petitioners' Appendix A at 20a. Congress chartered SIPC as a not-for-profit organization to make certain limited advances for customers in case of a broker's insolvency within the framework of the bankruptcy laws, and not to act as an insurer. Mishkin v. Peat, Marwick, Mitchell & Co., 744 F. Supp. 531, 557 (S.D.N.Y. 1990) ("SIPA is not

an insurance statute and was not intended to be an insurance-type statute."). See Secs. Investor Prot. Corp. v. Associated Underwriters, Inc., 423 F.Supp. 168, 171 (D.Utah 1975) ("SIPC is not an insurer ..."); SEC v. Albert & Maguire Sec. Co., 560 F.2d 569, 572 n. 2 (3d Cir. 1977); In re Stratton Oakmont, Inc., 42 Bank. Ct. Dec. (LRP) 48, at 220 (S.D.N.Y. 2003). Petitioners wrongly imply (petition at 4) that SIPC is the equivalent of the Federal Deposit "Insurance" Corporation. Congress specifically considered creating a Federal Broker-Dealer "Insurance" Corporation, but rejected that notion, concluding that such a designation would be both misleading and out of step in the risk-based investment marketplace that differs markedly from the banking world. See SIPC v Morgan, Kennedy & Co., 533 F.2d 1314, 1318 (2d Cir.) ("SIPA and FDIA [the Federal Deposit Insurance Act] are independent statutory schemes, enacted to serve the unique needs of the banking and securities industries, respectively. Congress recognized this when it rejected several early versions of the SIPA bill which were patterned on FDIA and which extended insurance coverage to certain beneficial interests represented by customer accounts.") (emphasis added), cert. den. sub nom., Trustees of the Reading Body Works, Inc. v. SIPC, 426 U. S. 936 (1976).[2]

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[2] It is noteworthy that the denial of an insurance claim for fictitious Madoff profits has been upheld, the court noting that the loss of fictitious profits is not a direct loss, and that withdrawals in excess of deposits would be subject to claw back in bankruptcy. Horowitz v. American Int'l Group, Inc., 2010 WL 3825737 (S.D.N.Y. Sept. 30, 2010), appeal pending, No. 10-4408 (2d Cir.).

In fact, SIPC is a non-profit membership organization created under SIPA. Its members consist of registered securities broker-dealers. SIPA § 78ccc(a)(2)(A). The membership contributes to a Fund which subsidizes the operations of SIPC and is used, within statutory limits, to satisfy the net equities of customers of member broker-dealers in liquidation under SIPA, to the extent customer property is insufficient. SIPA §§78ddd(c) and 78fff-3(a).

To be eligible for protection under SIPA, an investor must be a "customer." "Customer" is a term of art, referring not just to any investor but to investors eligible for protection. "Customer" is defined at SIPA section 78lll(2), and essentially, is an investor who has deposited cash and/or securities with the broker in the ordinary course of its business and who, on the date the brokerage firm fails financially,[3] has a claim against the broker-dealer for the return of the customer's property. That SIPA protects the custodial function, that is, the property that has been entrusted to the broker

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[3] What is owed to a customer is measured as of the "filing date." See SIPA §78lll(11) (net equity to be determined as of the filing date). The filing date usually is the date on which SIPC files the application for a customer protective decree unless, e.g., as in the BLMIS case, a receiver is appointed for the firm. In that event, the "filing date" is the date of commencement of the receivership case. See SIPA §78lll(7)(B). See also Order Appointing Receiver, SEC v. Bernard L. Madoff Investment Securities LLC, No. 1:08-cv-10791-LLS (S.D.N.Y. Dec. 12, 2008).

by or for the customer, is supported by a long line of authority. See SEC v. Kenneth Bove & Co., 378 F.Supp. 697, 699 (S.D.N.Y. 1974); SIPC v. Stratton Oakmont, Inc., 229 B.R. 273, 279 (Bankr. S.D.N.Y.) ("well established that SIPA protects customers ... who have entrusted to ... broker-dealers cash or securities in the ordinary course of business for the purpose of trading and investing"), aff'd sub nom., Arford v. Miller, 239 B. R. 698 (S.D.N.Y. 1999), aff'd, 210 F.3d 420 (2d Cir. 2000); In re Adler Coleman Clearing Corp., 204 B.R. 111, 114, 115 (Bankr. S.D.N.Y. 1997); SEC v. First Sec. of Chicago, 507 F.2d 417, 420 (7th Cir. 1974); In re Carolina First Sec. Group, Inc., 173 B. R. 884, 886 (Bankr. M.D.N.C. 1994) (no "customer" status as to property not entrusted to brokerage). See National Union Fire Ins. Co. v. Camp (In re Government Sec. Corp.), 972 F.2d 328, 331 (11th Cir. 1992) (purpose of SIPA is "to return to customers of brokerage firms their property or money"), cert. den., 507 U. S. 952 (1993); and SEC v. S. J. Salmon & Co., 375 F.Supp. 867, 871 (S.D.N.Y. 1974) (SIPA was designed to facilitate return of property to customers of insolvent firm or to replace such property when lost or misappropriated).

An investor may suffer other kinds of losses at the hands of the brokerage, but those losses are not "customer" losses. The fact that an investor was a customer at one time does not make him a customer for all time. See SEC v. F. O. Baroff Co., 497 F.2d 280, 282 n.2 (2d Cir. 1974); In re Stalvey & Associates, Inc., 750 F.2d 464, 471 (5th Cir. 1985) ("Customer status 'in the air' is insufficient to confer the SIPA's protection on a given transaction.") To be protected, the loss must be "occasioned by a broker's

liquidation." SIPC v. Stratton Oakmont, Inc., supra, 229 B.R. 279. See Miller v. DeQuine (In re Stratton Oakmont, Inc.), 42 Bank. Ct. Dec. (LRP) 48, at 220 (S.D.N.Y. 2003) (SIPA's main purpose to reverse losses resulting from broker's insolvency); In re Oberweis Sec., Inc., 135 B.R. 842, 846 (Bankr. N. D. Ill. 1991) (damage that would have occurred even if debtor not insolvent is not a direct result from insolvency and not protected under SIPA). Thus, claims for ordinary market loss, claims for damages resulting from a broker's misrepresentations or fraud are not "customer" losses. In re Klein, Maus & Shire, Inc., 301 B.R. 408, 421 (Bankr. S.D.N.Y. 2003) (claims for damages do not involve the return of customer property entrusted to broker and are not "customer" claims. Claims for damages resulting from misrepresentation, fraud or breach of contract are not protected and are general creditor claims); In re MV Sec., Inc., 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985) (no SIPA protection for innocent investor against broker's fraud); SEC v. Howard Lawrence & Co., 1 Bankr. Ct. Dec. (CRR) 577, 579 (Bankr. S.D.N.Y. 1975) (no SIPA protection for claims based on fraud or breach of contract); In re Bell & Beckwith, 124 B.R. 35, 36 (Bankr. N.D. Ohio 1990) (no protection for claims based on broker's fraudulent conduct). At best, such claims for damages are general creditor claims. In re Oberweis Sec., Inc., 135 B.R. 842, 846 (Bankr. N.D. Ill. 1991) (claim for damages resulting from broker's failure to invest funds as instructed are basis only for general creditor claim).

B. The Protection Afforded Customers

Persons who are "customers" receive preferred treatment in two ways. One, they share, pro rata, in customer property, a fund of property amassed by the SIPA trustee consisting of property received, acquired, or held by the broker-dealer for its customers. See SIPA §§78lll(4) and 78fff-2(c)(1). Customer property includes not only the property that the trustee finds in the broker's possession or control, upon his appointment as trustee, but property belonging to customers that has made its way into the hands of third parties and that the trustee, by law, is authorized to recapture for the benefit of customers. See SIPA §78fff-2(c)(3).

Two, to the extent customer property is insufficient to satisfy the claims of customers, SIPC may advance funds to the trustee for that purpose. Notably, although SIPC may advance funds prior to the collection and distribution of customer property so that customers can be satisfied more promptly, ultimately, customers are satisfied as if customer property had been fully collected and distributed, before SIPC funds are made available. Thus, to the extent of its advances as to any customer whose claim thereby is fully satisfied, SIPC stands in the shoes of that customer and is subrogated to the claims of the satisfied customer. See SIPA §78fff-3(a); and In re Bell & Beckwith, 937 F.2d 1104 (6th Cir. 1991).

If customers still are not fully satisfied from customer property and SIPC advances, they share, pro rata, in any general estate, with general creditors. SIPA §78fff-2(c)(1).

C. The Burden of Proof of the Claimant Seeking "Customer" Status

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

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

Sec. L. Rep. (CCH) ¶98,095, at 98,763 (S.D.N.Y. 1993).

II. GIVING EFFECT TO THE FICTITIOUS ACCOUNT STATEMENTS PERPETUATES THE PONZI SCHEME

A. Distribution Under SIPA

Far from reinforcing confidence in the marketplace, giving effect to the fictitious account statements undermines the securities laws by causing the money of investors who have yet to recover their principal deposits to continue to be used to pay fictitious profit to others. This is abundantly clear from an examination of how funds are distributed under SIPA.

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

> [Section §78fff-2(c)(1)], the operative provision with respect to customer property, provides that each customer will be allocated a ratable share of customer property based upon his net equity. This allocation is fundamental to the process of determining the extent to which SIPC protection will be available to a customer, because SIPC advances are applied to the difference between a customer's ratable share of customer property and his net equity claim....

Hearing on H. R. 8331 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, 95th Cong. 32 (1978).

As the foregoing indicates, the SIPC advance does not reduce the customer's net equity or, therefore, his claim against customer property. As stated in H.R. Rep. No. 95-746, at 29 (1977):

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

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

B. Examples of Distributions Under SIPA

The distribution scheme is illustrated below:

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

Assume that a brokerage firm in SIPA liquidation has two customers: Customer A and Customer B. Customer A has a net equity of $500,000 in securities. Customer B has a net equity of $3.5 million in securities. Their combined net

equities total $4 million. Assume also that the trustee collects $2 million in customer property. The satisfaction of A and B's net equities, based on a 50% pro rata distribution of customer property ($2 million ÷ $4 million), is as follows:[4]

Customer	Net Equity	Pro Rata Share Of Customer Property	SIPC Advance	Total Received by Customer	Amount Still Owed to Customer
A	$500K	$250K	$250K	$500K	$0
B	$3.5 mill.	$1.75 mill.	$500K	$2.25 mill.	$1.25 mill.

Customer A is fully satisfied, receiving 50% ($250,000), and the balance of his claim with an advance of SIPC funds. Because A is fully satisfied, any later distributions that would go to A instead go to SIPC, as subrogee. To allow A to receive the funds would give him more than the value of his claim. Thus, SIPC is subrogated to the claim of A to the extent of its advance for A, namely, $250,000. SIPC also is subrogated to the claim of B to the extent of its advance ($500,000), but will not stand in B's shoes as to any additional distribution of customer property until B has been fully satisfied.

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

[4] In the charts, "K" is used as an abbreviation for a thousand. A million is abbreviated by "mill."

If a trustee were able to collect all customer property immediately and distribute it to customers before SIPC advanced any funds for customers, then SIPC would never share as subrogee in customer property under SIPA §78fff-2(c)(1)(C) because no customer property would remain for distribution to it. However, because, in reality, the collection of customer property takes time, SIPC may advance funds to a trustee for customers even when the amount of customer property is unknown. See SIPA §78fff-2(b)(1). Under SIPA, customers do not have to wait to have their claims satisfied while the trustee collects customer property, even if ultimately, there would have been enough customer property to make customers whole without the use of SIPC funds. Once the customer is fully satisfied, SIPC is subrogated to the customer's claim against customer property. As illustrated below, whether or not customers are first satisfied with funds from SIPC, the result is the same.

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

Customer	Customer's Net Equity	SIPC Advance	No Customer Property Collected Yet	Total Received By Customer	Amount Still Owed
A	$500K	$500K	$0	$500K	$0
B	$3.5 mill.	$500K	$0	$500K	$3 mill.

If the trustee eventually collects $2 million, $250,000, which would have been A's pro rata share, will be distributed to SIPC in reimbursement of its advance for A because A has been fully satisfied. The remaining $1.75 million will be distributed to B, as its pro rata share of customer property, and leaving B still owed $1.25 million. Thus, whether the SIPC advance is made before or after customer property is distributed, the outcome is the same.

Scenario 3: An Illustration of the Impact of "Net Equity" on the Distribution of Customer Property

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

Assume that the brokerage is BLMIS and that while BLMIS is in business, Investor A deposits $2 million with the firm. Over time, the account "grows" to $4 million so that it includes the initial $2

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

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

Trustee's Approach:

Customer	Customer's Net Equity	Pro Rata Share of Customer Property	SIPC Advance	Total Received by Customer	Amount Still Owed Customer
A	$0	$0	$0	$0	$0
B	$2 mill.	$1 mill.	$500K	$1.5 mill.	$500K

Fictitious Statement Approach:

Custo mer	Custo-mer's Net Equity	Pro Rata Share of Customer Property	SIPC Advance	Total Re-ceived by Customer	Amount Still Owed to Customer
A	$2 mill.	$500K	$500K	$1 mill.	$1 mill.
B	$2 mill.	$500K	$500K	$1 mill.	$1 mill.

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

Under the fictitious statement approach, B would have recovered nothing while BLMIS was in business, having made no withdrawals from his account and having had his money given to A by BLMIS. In liquidation, B would recover $500,000 of customer property and $500,000 from SIPC for a total of $1 million on his $2 million claim. $1 million would still be owed to him.

In contrast, under the Trustee's approach, A would recover nothing in the SIPA liquidation and B would receive all of the customer property plus the SIPC advance, for a total of $1.5 million. B, who is the only party who is out-of-pocket, would recover

$500,000 more under the Trustee's approach than under the fictitious statement approach. Likewise, under the Trustee's approach, the fake profits already received by A would not continue to grow whereas they would under the fictitious statement approach.

From this illustration, it is clear that every dollar received by A, who already has recaptured his initial investment and more, is one dollar less for B who has yet to recover his initial investment. Thus, even in liquidation, as he did while the firm was in business, A continues to receive B's money, to the detriment of B, under the fictitious statement approach. As the BLMIS Trustee already has collected more than $9 billion for customers, with a number of lawsuits pending in which he seeks to recover more, see www.madofftrustee.com, the calculation of net equity will have a genuine impact on the amount of customer property received by each customer including those investors who already recovered their principal and received sizeable sums of money belonging to others.

III. THE SECOND CIRCUIT'S DECISION COMPORTS WITH APPLICABLE LAW

Petitioners erroneously contend that the issue they present is one of first impression. Petition at 9. In fact, there is ample support for the decision of the Second Circuit, all of which is fully consistent with the Court's conclusion.

A. Second Circuit Law

The Second Circuit has issued at least two significant decisions that are relevant to the case at hand. One of those decisions, New Times I, was discussed briefly above, and because of its importance, is examined in more detail below.

Customers with two kinds of claims were involved in New Times I. One group of customers received account statements indicating that the customers were invested in real mutual funds. Although the trades had not actually occurred, the account statements mirrored in all respects what would have happened had the transactions taken place. See New Times I, 371 F.3d at 74. Unlike the BLMIS case, no price manipulation was involved. The other group consisted of customers who gave money to the broker to invest in mutual funds that ultimately never existed, and whose account statements showed fake securities positions, artificial interest and fake dividend reinvestments. Id. at 74. The position of SIPC and the trustee in the case was that the first group of customers had claims for securities while the second group, whose securities never existed, had claims for cash. Id. at 74-75, 83.[5]

In resolving the issue of what the customers with claims for fictitious securities were owed, the Court applied a two-pronged analysis. First, in deciding

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

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

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

In reaching its decision, the Court in New Times I took note of the decision in another SIPA case, Theodore H. Focht, Trustee v. Tessie C. Athens (In re Old Naples Securities, Inc.), 311 B. R. 607 (M.D. Fla. 2002) ("Old Naples"). See 371 F.3d at 88. In

that case in which non-existent bonds were "sold" and other investors' money was used to pay previous investors, the District Court remarked as follows with respect to "net equity" and the claimants' assertion that fake interest should be allowed:

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

311 B. R. at 616-617.

Significantly, the Old Naples Court agreed with the analysis set forth in In re C. J. Wright & Co., 162 B. R. 597 (Bankr. M.D. Fla. 1993) ("C. J. Wright"). There, responding to the position of the claimants that they were entitled to the return of their principal as well as interest that they would have

earned if the debtor actually had bought certificates of deposit ("CD") for them and the CDs had matured, the Bankruptcy Court stated:

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

162 B. R. at 609-610.

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

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

Consistent with New Times I, the Trustee in this case deemed the customers to have claims for securities because the claimants received fictitious account statements indicating securities were in their accounts. However, following the precedent of New Times and other cases, the Trustee declined otherwise to give effect to the fictitious statements because although the names of the issuers of many of the securities were "real," the fictitious statements bore no relation to reality, the prices having been determined not by the securities markets but by

Madoff, and the fake "profits" having been pre-determined by him.

B. SIPA Section 78fff-2(b)

The decision of the Second Circuit also is fully consistent with SIPA and rules thereunder. Under SIPA section 78fff-2(b), a trustee must satisfy customers' net equity claims "insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee." "Books and records" of a debtor are more than just account statements. See, e.g., SEC Rule 17a-3, 17 C.F.R. §240.17a-3 (2011) (specifying no fewer than twenty-two categories of "books and records" to be maintained by broker-dealers). See also 15 U.S.C. §78q. Furthermore, if the books and records are unreliable, the claimant still must prove the obligation "to the satisfaction of the trustee." In the BLMIS case, the books and records and other information showed that the trades were backdated and fictitious, that the profits were fictitious, that certain claimants withdrew more than they deposited into their accounts, and that "securities" "purchased" with fake sales proceeds in fact were never paid for by the customer. For the Trustee to ignore what the books and records showed and to satisfy net equity claims based solely upon fictitious account statements would violate SIPA §78fff-2(b).

IV. THE DECISION OF THE SECOND CIRCUIT IS CORRECT IN NOT ENDORSING SECURITIES LAW VIOLATIONS

A. SIPA As Part of the Securities Laws

Implicit in the two New Times decisions is the recognition that to give unquestioning effect to fictitious account statements is to rubber-stamp fraud and other bad acts of a broker and to allow investors to benefit from that wrongful conduct. In that vein, courts consistently have recognized that SIPA and rules promulgated thereunder "manifest a design to deny protection to transactions tainted by fraud." Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.), 263 B.R. 406, 435 (S.D.N.Y. 2001) ("Adler"). See Arford v. Miller (In re Stratton Oakmont, Inc.), 239 B.R. 698, 701-702 (S.D.N.Y. 1999), aff'd, 210 F.3d 420 (2d Cir. 2000); SEC v. S.J. Salmon & Co., 375 F. Supp. 867, 870-71 (S.D.N.Y. 1974); In re Adler, Coleman Clearing Corp., 198 B.R. 70, 75 (Bankr. S.D.N.Y. 1996). Where a claimant undertakes no market risk, and claims entitlement to cash or securities only because of a broker's fraud, no "customer" relief under SIPA is available. See, e.g., supra, New Times I and II; Adler, 263 B.R. at 435. One reason for this outcome is that SIPC's goal of customer protection must be carried out consistent with the securities laws since SIPA itself is a part of the securities laws.

Except as otherwise provided in SIPA, the provisions of the Securities Exchange Act of 1934, 15 U.S.C. §78a et seq. ("the 1934 Act"), apply as if SIPA were an amendment to, and a section of the 1934

Act. SIPA §78bbb. Moreover, as explicitly provided in SIPA, while a primary function of the statute is to provide some protection to investors, another central function is to reinforce the broker-dealer's financial responsibility requirements so that the securities laws are strengthened.[6] Cf., SEC v. Packer, Wilbur & Co., 498 F.2d 978, 985 (2d Cir. 1974) (purpose of SIPA is to strengthen market. Goal is not served by reimbursing from public funds one whose fraudulent activities have weakened it). In considering the Series 500 Rules, 17 C.F.R. §300.500 et seq., adopted by SIPC and relating to whether customers have claims for cash or securities and the inapplicability of those rules with respect to certain fraudulent and similar type transactions, the District Court in Adler, supra, 263 B.R. at 434-435, commented:

> [The broker's] extensive fraud has overarching significance and implications for the transactions that culminated in the Challenged Trades.... Contrary to Appellants' perceptions of these events, [the broker's] deeds cannot be ignored in assessing whether Appellants are entitled to enforce the Challenged Trades. While it is true that one of SIPA's primary objectives is to protect individual customers from financial

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

> hardship, the legislation also embodies parallel and complementary aims....
>
> * * * *
>
> The SIPC 500 Rules, promulgated in 1988, ... reflect these ends. They safeguard securities customers' legitimate claims to cash and securities held by the debtor in their accounts prior to filing date, and also manifest a design to deny protection to transactions tainted by fraud.

The instant petition should be denied because the decision of the Second Circuit is consistent with the legislative intent that the SIPA protection not be administered at the expense of undermining the securities laws. The District Court's decision in Adler contains an extensive analysis in this regard, and therefore is discussed in detail below.

B. Adler

In an appeal from a decision of the Bankruptcy Court, the District Court in Adler, discussed many of the grounds for refusing protection to an investor in a SIPA case involving fraudulent activity of a broker and artificial profits created by the broker. Almost all of the grounds apply with equal force here, underscoring the soundness of the Second Circuit's decision.

In Adler, the District Court denied "customer" protection to claimants whose broker reported to them that it had sold at inflated, above-market prices, certain near worthless "house stocks" in their

accounts. The house stocks, although of negligible value, were nonetheless actual securities issued by existing corporations. The broker then used the fictional proceeds from these "sales" to buy valuable "blue chip" securities for their accounts. See Adler, 263 B.R. at 421-22. In denying the claimants' claim for the "blue chip" securities, the Court explained, inter alia, that the "sales" of the "house stocks" were reported to claimants at prices far above those the claimants could have obtained had the stocks been sold in the open market, and that, had the sales actually occurred at those prices, claimants would not have had enough cash to buy the "blue chips" sought in the liquidation. See Adler, 263 B.R. at 430 ("[T]here was no real cash in the Claimants' accounts because the trades never settled and the proceeds yielded by the Challenged Sales of House Stock, even at the inflated prices manipulated by Hanover [the broker], were not enough to cover the cost of the Blue Chips"). The Court concluded that affording the claimants customer status under SIPA was impermissible, observing that it:

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

Adler, 263 B.R. at 434. The District Court relied on a few different grounds in arriving at its ruling, some of which are discussed below.

i. **The Broker as the Claimant's Agent**

In Adler, the District Court rejected the claimants' contention that they were entitled to "customer" status due to their lack of knowledge of the broker's fraud. The Court found that, as beneficiaries of their broker/agent's fraud, they were chargeable with the broker's actions and intent. See 263 B.R. at 453-58.

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

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

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

Likewise, in BLMIS, any acts, knowledge and intent of BLMIS as agent were imputed to each investor as principal and to the extent that any investor sought to benefit from the agent's fraud and price manipulation, the investor would be chargeable with the agent's actions, knowledge, and intent.

ii. Fraudulent Trades Are Unenforceable

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

V. THE DECISION OF THE SECOND CIRCUIT IS CONSISTENT WITH SIPA'S ROLE AS A BANKRUPTCY STATUTE

The holding of the Second Circuit that investors, no matter how innocent, cannot benefit from a broker's fraud is echoed in the SIPA trustee's avoidance powers. SIPA is not only a securities law, but it is a bankruptcy law. SIPA section 78fff(b) makes applicable to the liquidation, to the extent consistent with SIPA, all of the provisions of Title 11 that apply in a Chapter 7 case except for subchapters I and II of chapter 7. Relevant here is the authority given to the trustee under SIPA section 78fff-2(c)(3) to recapture, through avoidance actions, customer property transferred by the debtor.

See In re Park South Sec., LLC, 326 B. R. 505, 512-513 (Bankr. S.D.N.Y. 2005).

As the District Court in Adler noted, the avoidance powers are critical to an important objective of both ordinary bankruptcy and SIPA liquidations, namely, maximizing recovery for ratable distribution to all customers. As the Court stated:

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

Adler, 263 B. R. at 463.

In Adler, the challenged trades were held avoidable as fraudulent transfers under the Bankruptcy Code ("Code") and state law made applicable under the Code. The same result was reached in the S. J. Salmon & Co., Inc. ("Salmon") SIPA liquidation proceeding. At issue there were trades that the trustee alleged were neither bona fide nor the result of arm's length transactions in the open market, but recorded only on the books and records of the brokerage in order to improve the

position of certain preferred customers in the face of the imminent liquidation of the firm. In ruling in favor of the trustee, the Court concluded that the "trades" were transfers made with actual intent to defraud creditors, a deliberate attempt to defraud SIPC under SIPA, and done "without fair consideration." The Court also noted that the true value of the trades was "not the prices quoted on that date, but rather the quotations published by dealers after debtor's cessation of business...," and that the "artificially high prices would vanish when [the broker] ceased acting as a market maker." SIPC v. S. J. Salmon, No. 72 Civ. 560, 1973 U.S. Dist. LEXIS 15606, at *19, *20 (S.D.N.Y. Aug. 8, 1973). Significantly, the Court also remarked:

> But SIPA was not intended to make the fraudulent transfer provisions of the Bankruptcy Act inoperative as to stockbroker-debtors in SIPA proceedings. While SIPA was intended to protect customers there is nothing in its provisions to indicate that less preferred creditors are to be denied the protection of the provisions which bar a debtor from making fraudulent transfers at their expense.

Id. at *31. See Gowan v. The Patriot Grp., LLC (In re Dreier LLP), 452 B.R. 391, 439-40 (Bankr. S.D.N.Y. 2011) (holding that chapter 11 trustee's suit for recovery of fictitious profits as fraudulent transfers could proceed because defendants did not provide reasonably equivalent value for the transfers); Sender v. Buchanan (In re Hedged-Investments Assoc., Inc.), 84 F.3d 1286, 1290 (10th

Cir. 1996) (allowing a trustee to bring a fraudulent transfer suit against a Ponzi scheme investor who withdrew more than she deposited).

VI. THE SECOND CIRCUIT DECISION IS CONSISTENT WITH THE LANGUAGE OF SIPA AND THE LEGISLATIVE INTENT

In the face of the overwhelming authority supporting the Second Circuit's decision, the petitioners argue that a failure to adopt the fictitious account statements will foster uncertainty among investors who will no longer be able to rely upon account statements. With no basis in the law, they cling to an imaginary standard that claims must be decided under SIPA strictly in accordance with account statements, even if fictitious. While alleging that the Trustee and the Court have disregarded the law, it actually is the Petitioners who fail to apply it. Under SIPA section 78fff-2(b), obligations of the debtor must be ascertainable from the debtor's books and records which, as discussed above, include much more than just account statements, or they must otherwise be established to the satisfaction of the trustee. In the case at hand, the Trustee followed section 78fff-2(b) to the letter. The Trustee rejected the account statements to the extent of the fiction embodied in them, consistent with section 78fff-2(b), and two courts sustained his position. The petitioners argue that the failure to adhere, in every instance, to the account statements turns the statutory definition of net equity into a chameleon, a "dangerous principle." Petition at 10. The premise is wrong. The "dangerous principle" is when the thief, as the petitioners in effect advocate, is allowed to dictate the extent and availability of protection

because fictitious account statements must be blindly followed. That is the subversion of the law.

The decision of the Second Circuit is correct because it recognizes that there is no SIPA protection for claims that are based on damages. In the final analysis, to the extent that the petitioners in this case have been harmed by the Debtor by more than the net amounts deposited by them, their claims, at best, are for damages which are general creditor, and not customer, claims. This is the true nature of their claims, but as to such losses, investors are not protected under SIPA. As stated by the Ninth Circuit in In re Brentwood Sec., Inc., 925 F.2d 325, 330 (9th Cir. 1991):

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

See SEC v. Packer, Wilbur & Co., supra, 498 F.2d at 983 ("SIPA was not designed to provide full protection to all victims of a brokerage collapse. Its purpose was to extend relief to certain classes of customers.")

CONCLUSION

For all of the aforementioned reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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No. 11-986

IN THE

Supreme Court of the United States

LAWRENCE R. VELVEL,

Petitioner,

v.

IRVING H. PICARD, TRUSTEE,

Respondent.

On Petition For a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF THE SECURITIES INVESTOR PROTECTION CORPORATION IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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COUNTERSTATEMENT OF THE QUESTION PRESENTED

The trustee of a securities broker-dealer in liquidation under the Securities Investor Protection Act, 15 U.S.C. §78aaa et seq. ("SIPA"), satisfies the obligations of the broker-dealer to its customers "insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee." The broker-dealer in this case issued to its customers fictitious account statements that showed fictitious securities trades at fictitious prices invented by the broker-dealer to yield fictitious "profits." The petitioners rely upon the fictitious account statements in claiming that they are owed the fictitious amounts shown on the fictitious statements. Any such amounts previously paid to them actually were funds deposited with the broker-dealer by other investors and not the product of real trades. Under these circumstances, where the books and records of the debtor show that "profits" were fictitious, and where honoring the fictitious account statements perpetuates the broker-dealer's fraudulent scheme by continuing the practice of using some investors' money to benefit others, the question presented is whether the Court of Appeals erred in disregarding the fictitious account statements and in affirming the lower court's decision that customers in the liquidation proceeding are owed the net amount of their deposits with the broker-dealer and not fictitious profit.

CORPORATE DISCLOSURE STATEMENT

The Securities Investor Protection Corporation ("SIPC") is a federally chartered corporation under the Securities Investor Protection Act, 15 U.S.C. §78aaa et seq. SIPC has no parent and there is no publicly held company that owns 10% or more of stock in it.

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No. 11-986

IN THE

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LAWRENCE R. VELVEL,
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IRVING H. PICARD, TRUSTEE,
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On Petition For a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF OF THE SECURITIES INVESTOR PROTECTION CORPORATION IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

COUNTERSTATEMENT OF THE CASE

A. Commencement of the Liquidation Proceeding

On December 15, 2008, upon an application by the Securities Investor Protection Corporation

("SIPC"),[1] the United States District Court for the Southern District of New York ("District Court") entered an order placing Bernard L. Madoff Investment Securities LLC ("BLMIS" or "Debtor") in liquidation under SIPA and appointing Irving H. Picard as trustee for the liquidation of the firm ("Trustee"). Consistent with SIPA section 78eee(b)(4), the District Court removed the case to the Bankruptcy Court for that District ("Bankruptcy Court").

Pursuant to SIPA section 78fff-2(a)(1), the Trustee caused notice of the liquidation proceeding to be published and mailed claim forms to "customers" and other creditors of the Debtor. Upon his review of "customer" claims received, the Trustee issued written determinations notifying the claimants whether their claims had been allowed or denied and informing them of their right to seek judicial review if they disagreed with a determination. As to each "customer" claim, the Trustee's determination contained his calculation of the claimant's "net equity." Net equity is the net amount owed to the customer by the broker-dealer under SIPA section 78lll(11).

---

[1] 15 U.S.C. section 78eee(d) makes SIPC a party in interest as to all matters in the SIPA proceeding, "with the right to be heard on all such matters…."

For convenience, references hereinafter to provisions of SIPA shall omit "15 U.S.C."

B. The BLMIS Fraud

An investigation by the Trustee of BLMIS had revealed that BLMIS and Bernard L. Madoff ("Madoff"), its principal, ran a Ponzi scheme, and that BLMIS had issued fictitious account statements to customers, showing trades that never occurred, at backdated prices that were selected by Madoff to create fictitious returns that Madoff wanted investors to receive. Details of the fraud were confirmed by Frank DiPascali, Jr., a chief Madoff lieutenant, in his guilty plea to a criminal complaint. In relevant part, the complaint provided:

> 11. On a regular basis, Madoff provided guidance to [DiPascali], and, through [DiPascali], to other co-conspirators, about the gains or losses that Madoff wanted to be reflected in the account statements of the … Clients. Based on that guidance, [DiPascali] and other co-conspirators prepared model baskets of S&P 100 stocks based on historical market prices and tracked how those hypothetical baskets would have performed in the actual marketplace to determine whether and when to "enter the market." Whenever Madoff informed [DiPascali] that he had decided to "enter the market," [DiPascali] and other co-conspirators caused BLMIS computer operators to enter the data related to the chosen basket of securities into the computer that

> maintained the books and records of the … business. * * * *
>
> When Madoff made a final decision to "enter the market," [DiPascali] and other co-conspirators would cause the computer to produce tens of thousands of false documents that purported to confirm the purchases of securities that in fact had not been purchased.
>
> 12. The purported trades by which BLMIS supposedly "entered the market" were sometimes priced using data from market activity that occurred one or more days prior to the date on which the decision to "enter the market" was finalized. Because none of the "trades" actually occurred, Madoff, [DiPascali], and other co-conspirators relied on historical price and trading volume data obtained from published sources of market information. With the benefit of hindsight, Madoff and [DiPascali] chose the prices at which securities purportedly were purchased in light of Madoff's objectives. * * *

Information filed on August 11, 2009, at 6-7, United States v. Frank DiPascali, Jr., No. 1:09-cr-00764-RJS-1 (S.D.N.Y.), available at www.justice.gov/usao/nys/madoff/20090811dipascali

informationsigned.pdf. As Mr. DiPascali testified in his criminal case:

> On a regular basis I used hindsight to file historical prices on stocks then I used those prices to post purchase of sales to customer accounts as if they had been executed in realtime. On a regular basis I added fictitious trade data to account statements of certain clients to reflect the specific rate of earn return that Bernie Madoff had directed for that client.

Plea Hearing Transcript at 47, United States v. DiPascali, No. 09 Cr. 764 (S.D.N.Y. Aug. 11, 2009), available at http://www.justice.gov/usao/nys/madoff/dipascaliplea81109.pdf.

Because actual trades did not occur, investors who withdrew funds from their accounts received moneys deposited by other investors. Even if the investor did not immediately withdraw the fictitious profit, he benefitted from the fraud. Thus, the fictitious account statements showed that an investor's fictitious profits would be used to "buy" other securities for the investor resulting in fictitious securities positions in his account for which the investor never paid.

C. The Treatment of Fictitious Profit

In 2004, the Second Circuit had issued a decision in a SIPA case in which the Court held that customers would have claims for securities if they

reasonably believed that securities had been purchased for them even if the securities had not actually been bought. A claim for securities would entitle the customer to up to $500,000 of protection from SIPC instead of $100,000, the limit of protection if a customer was owed cash. The Court also held, however, that where the "investment" and the account statements were fictitious, the customer's net equity would be the amount of cash deposited by the customer with the broker-dealer. Thus, the customer would be eligible for up to $500,000 of SIPA protection, and would receive back the net amount of his cash deposited with the broker, with no "customer" claim to bogus interest or dividend reinvestments. In re New Times Securities Services, Inc., 371 F.3d 68, 88 (2d Cir. 2004) ("New Times I").

The Trustee in the BLMIS case determined customers' "net equity" consistent with the law of the Circuit. The customer's net equity would be the net amount of cash deposited by the customer with the brokerage. Net equity would not include the fictitious profits invented by Madoff and customers would not be entitled to them.

D. The Claim by the Petitioner

The petitioner filed a "customer" claim in the liquidation proceeding seeking $3,903,236.86 in securities which represented the purported value of his account based on a fictitious account statement issued to him by BLMIS. Following a review of the claim, the Trustee issued a determination denying the claim on the ground that the Petitioner withdrew $341,012.09 more from his account at BLMIS than

he deposited into it. The Trustee attached to the determination a list of all deposits and withdrawals from the account.

The petitioner filed an objection to the determination in which he did not challenge the Trustee's calculation but simply stated that he disagreed with the determination based on the views of others who had objected to the net equity calculus in the proceeding. Thereafter, the petitioner served SIPC and the Trustee with discovery requests. See Petition at 8, 22. In essence, the requests sought all documents relating to the Trustee's and SIPC's reasons for not calculating net equity according to the fictitious account statements. In a notice filed with his requests, Petitioner indicated that he needed the information to determine whether the Trustee's and SIPC's position on net equity was due to a desire to save SIPC money.

The Trustee and SIPC filed motions for a protective order.[2] The Court granted the motions, finding good cause for the order "because the discovery requests, having much of the indicia of a fishing expedition, are overbroad, unduly burdensome, expensive, irrelevant, and subject to privilege." Petition, Appendix E. Petitioner did not seek leave to appeal from the discovery order. Nor did he join in seeking leave to appeal, on an

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[2] The background of the discovery requests is set out in the Motion for Protective Order Denying Discovery Sought by Claimant Lawrence R. Velvel Through His Request for Production of Documents, filed by SIPC, in SIPC v. Bernard L. Madoff Investment Securities LLC, Adv. Pro. No. 08-01789 (BRL) (Bankr. S.D.N.Y. Oct. 30, 2009), ECF No. 555, at 3-5.

expedited basis, the Bankruptcy Court's decision which upheld the Trustee's calculation of net equity, and which subsequently was upheld by the Second Circuit. Petition at 10.

The petitioner now seeks review by this Court, asking the Court to give effect to the fictitious account statements which, if allowed, will perpetuate the Madoff fraud and benefit the petitioner.

SIPC respectfully submits that the Court should deny the petition.

ARGUMENT

The petitioner contends that the Trustee and SIPC adopted the calculation of net equity for a nefarious reason: to save SIPC money. The accusation is unfounded and absurd, but even assuming incorrectly, arguendo, that it had merit, the Trustee's and SIPC's motives are irrelevant. The reality is that the Second Circuit's decision is amply supported by the law, and that to adopt the petitioner's point of view, would be to continue the Ponzi scheme.

Giving effect to the fictitious statements undermines a fundamental and sacred principle of a free market – the determination of market price by supply and demand, and not by manipulation. More immediately, in this case, giving effect to the fictitious account statements and the fictitious prices harms those already most aggrieved by Madoff's actions: investors who did not withdraw any or all of their funds from the brokerage and

whose funds therefore were used to pay fictitious profits to other investors. In the parlance of the BLMIS case, the latter investors are "net losers." They stand in contrast to investors, such as the petitioner, who took out more from their accounts than they deposited and therefore, received fictitious profits. They are the "net winners."

In order to understand how and why the net losers are harmed by the petitioner's approach, it is useful to consider preliminarily the nature of SIPA protection and the order of distribution of assets in a SIPA case.

I. OVERVIEW OF SIPA

A. SIPC and Customer Status

SIPC is a non-profit membership organization created under SIPA. Its members consist of registered securities broker-dealers. SIPA § 78ccc(a)(2)(A). The membership contributes to a Fund which subsidizes the operations of SIPC and is used, within statutory limits, to satisfy the net equities of customers of member broker-dealers in liquidation under SIPA, to the extent customer property is insufficient. SIPA §§78ddd(c) and 78fff-3(a).

To be eligible for protection under SIPA, an investor must be a "customer." "Customer" is a term of art, referring not just to any investor but to investors eligible for protection. "Customer" is defined at SIPA section 78lll(2), and essentially is an investor who has deposited cash and/or securities with the broker in the ordinary course of its

business and who, on the date the brokerage firm fails financially,[3] has a claim against the broker-dealer for the return of the customer's property. That SIPA protects the custodial function, that is, the property that has been entrusted to the broker by or for the customer, is supported by a long line of authority. See SEC v. Kenneth Bove & Co., 378 F.Supp. 697, 699 (S.D.N.Y. 1974); SIPC v. Stratton Oakmont, Inc., 229 B.R. 273, 279 (Bankr. S.D.N.Y.) ("well established that SIPA protects customers ... who have entrusted to ... broker-dealers cash or securities in the ordinary course of business for the purpose of trading and investing"), aff'd sub nom., Arford v. Miller, 239 B. R. 698 (S.D.N.Y. 1999), aff'd, 210 F.3d 420 (2d Cir. 2000); In re Adler Coleman Clearing Corp., 204 B.R. 111, 114, 115 (Bankr. S.D.N.Y. 1997); SEC v. First Sec. of Chicago, 507 F.2d 417, 420 (7th Cir. 1974); In re Carolina First Sec. Group, Inc., 173 B.R. 884, 886 (Bankr. M.D.N.C. 1994) (no "customer" status as to property not entrusted to brokerage). See National Union Fire Ins. Co. v. Camp (In re Government Sec. Corp.), 972 F.2d 328, 331 (11th Cir. 1992) (purpose of SIPA is "to return to customers of brokerage firms their property or money"), cert. den., 507 U. S. 952 (1993);

[3] What is owed to a customer is measured as of the "filing date." See SIPA §78lll(11) (net equity to be determined as of the filing date). The filing date usually is the date on which SIPC files the application for a customer protective decree unless, e.g., as in the BLMIS case, a receiver is appointed for the firm. In that event, the "filing date" is the date of commencement of the receivership case. See SIPA §78lll(7)(B). See also Order Appointing Receiver, SEC v. Bernard L. Madoff Investment Securities LLC, No. 1:08-cv-10791-LLS (S.D.N.Y. Dec. 12, 2008).

and SEC v. S. J. Salmon & Co., 375 F.Supp. 867, 871 (S.D.N.Y. 1974) (SIPA was designed to facilitate return of property to customers of insolvent firm or to replace such property when lost or misappropriated).

An investor may suffer other kinds of losses at the hands of the brokerage, but those losses are not "customer" losses. The fact that an investor was a customer at one time does not make him a customer for all time. See SEC v. F. O. Baroff Co., 497 F.2d 280, 282 n.2 (2d Cir. 1974); In re Stalvey & Associates, Inc., 750 F.2d 464, 471 (5th Cir. 1985) ("Customer status 'in the air' is insufficient to confer the SIPA's protection on a given transaction.") To be protected, the loss must be "occasioned by a broker's liquidation." SIPC v. Stratton Oakmont, Inc., 229 B.R. at 279. See Miller v. DeQuine (In re Stratton Oakmont, Inc.), 42 Bank. Ct. Dec. (LRP) 48, at 220 (S.D.N.Y. 2003) (SIPA's main purpose to reverse losses resulting from broker's insolvency); In re Oberweis Sec., Inc., 135 B.R. 842, 846 (Bankr. N. D. Ill. 1991) (damage that would have occurred even if debtor was not insolvent is not a direct result from insolvency and is not protected under SIPA). Thus, claims for ordinary market loss, claims for damages resulting from a broker's misrepresentations or fraud are not "customer" losses. In re Klein, Maus & Shire, Inc., 301 B.R. 408, 421 (Bankr. S.D.N.Y. 2003) (claims for damages do not involve the return of customer property entrusted to broker and are not "customer" claims. Claims for damages resulting from misrepresentation, fraud or breach of contract are not protected and are general creditor claims); In re MV Sec., Inc., 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985) (no SIPA protection for innocent investor

against broker's fraud); SEC v. Howard Lawrence & Co., 1 Bankr. Ct. Dec. (CRR) 577, 579 (Bankr. S.D.N.Y. 1975) (no SIPA protection for claims based on fraud or breach of contract); In re Bell & Beckwith, 124 B.R. 35, 36 (Bankr. N.D. Ohio 1990) (no protection for claims based on broker's fraudulent conduct). At best, such claims for damages are general creditor claims. In re Oberweis Sec., Inc., 135 B.R. 842, 846 (Bankr. N.D. Ill. 1991) (claim for damages resulting from broker's failure to invest funds as instructed are basis only for general creditor claim).

B. The Protection Afforded Customers

Persons who are "customers" receive preferred treatment in two ways. One, they share, pro rata, in customer property, a fund of property amassed by the SIPA trustee consisting of property received, acquired, or held by the broker-dealer for its customers. See SIPA §§78lll(4) and 78fff-2(c)(1). Customer property includes not only the property that the trustee finds in the broker's possession or control, upon his appointment as trustee, but property belonging to customers that has made its way into the hands of third parties and that the trustee, by law, is authorized to recapture for the benefit of customers. See SIPA §78fff-2(c)(3).

Two, to the extent customer property is insufficient to satisfy the claims of customers, SIPC may advance funds to the trustee for that purpose. As the Second Circuit correctly noted, Appendix A to the Petition at 22A, the SIPC Fund is not "insurance," and SIPC is not an insurer. See, e.g., Secs. Investor Prot. Corp. v. Associated

Underwriters, Inc., 423 F.Supp. 168, 171 (D.Utah 1975) ("SIPC is not an insurer ..."); SEC v. Albert & Maguire Sec. Co., 560 F.2d 569, 572 n. 2 (3d Cir. 1977); In re Stratton Oakmont, Inc., 42 Bank. Ct. Dec. (LRP) 48, at 220 (S.D.N.Y. 2003). Notably, although SIPC may advance funds prior to the collection and distribution of customer property so that customers can be satisfied more promptly, ultimately, customers are satisfied as if customer property had been fully collected and distributed, before SIPC funds are made available. Thus, to the extent of its advances as to any customer whose claim thereby is fully satisfied, SIPC stands in the shoes of that customer and is subrogated to the claims of the satisfied customer. See SIPA §78fff-3(a); and In re Bell & Beckwith, 937 F.2d 1104 (6th Cir. 1991).

To the extent customers still are not fully satisfied from customer property and SIPC advances, they share, pro rata, in any general estate, with general creditors. SIPA §78fff-2(c)(1).

C. The Burden of Proof of the Claimant Seeking "Customer" Status

Because of the preferred treatment accorded "customers" under SIPA, the burden is on the claimant to establish both his eligibility as a customer and what he is owed. See SIPC v. I.E.S. Mgmt. Group, 612 F.Supp. 1172, 1177 (D.N.J. 1985) ("customers" under SIPA receive preferential treatment by being satisfied ahead of general creditors), aff'd w/o opinion, 791 F.2d 921 (3d Cir. 1986). See also In re Adler Coleman Clearing Corp.,

198 B.R. 70, 71 (Bankr. S.D.N.Y. 1996) ("person whose claim against the debtor qualifies as a 'customer claim' is entitled to preferential treatment"); In re Hanover Square Sec., 55 B.R. 235, 237 (Bankr. S.D.N.Y. 1985) ("[a]ffording customer status confers preferential treatment"); In re Government Sec. Corp., 90 B.R. 539, 540 (Bankr. S.D. Fla. 1988) ("customers" under SIPA have "preferred status").

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

II. GIVING EFFECT TO THE FICTITIOUS ACCOUNT STATEMENTS PERPETUATES THE PONZI SCHEME

A. Distribution Under SIPA

Far from reinforcing confidence in the marketplace, giving effect to the fictitious account statements undermines the securities laws by causing the money of investors who have yet to recover their principal deposits to continue to be

used to pay fictitious profit to others. This is abundantly clear from an examination of how funds are distributed under SIPA.

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

> [Section §78fff-2(c)(1)], the operative provision with respect to customer property, provides that each customer will be allocated a ratable share of customer property based upon his net equity. This allocation is fundamental to the process of determining the extent to which SIPC protection will be available to a customer, because SIPC advances are applied to the difference between a customer's ratable share of customer property and his net equity claim....

Hearing on H. R. 8331 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, 95th Cong. 32 (1978). As the foregoing indicates, the SIPC advance does not reduce the customer's net equity or, therefore, his claim against customer property. As stated in H. R. Rep. No. 95-746, at 29 (1977):

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

funds from SIPC up to the amount permitted by the bill.

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

B. Examples of Distributions Under SIPA

The distribution scheme is illustrated below:

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

Assume that a brokerage firm in SIPA liquidation has two customers: Customer A and Customer B. Customer A has a net equity of $500,000 in securities. Customer B has a net equity of $3.5 million in securities. Their combined net equities total $4 million. Assume also that the trustee collects $2 million in customer property. The satisfaction of A and B's net equities, based on a 50% pro rata distribution of customer property ($2 million ÷ $4 million), is as follows:[4]

[4] In the charts, "K" is used as an abbreviation for a thousand. A million is abbreviated by "mill."

Customer	Net Equity	<u>Pro Rata</u> Share Of Customer Property	SIPC Advance	Total Received by Customer	Amount Still Owed to Customer
A	$500K	$250K	$250K	$500K	$0
B	$3.5 mill.	$1.75 mill.	$500K	$2.25 mill.	$1.25 mill.

Customer A is fully satisfied, receiving 50% ($250,000) and the balance of his claim with an advance of SIPC funds. Because A is fully satisfied, any later distributions that would go to A instead go to SIPC, as subrogee. To allow A to receive the funds would give him more than the value of his claim. Thus, SIPC is subrogated to the claim of A to the extent of its advance for A, namely, $250,000. SIPC also is subrogated to the claim of B to the extent of its advance ($500,000), but will not stand in B's shoes as to any additional distribution of customer property until B has been fully satisfied.

<u>Scenario 2</u>: An Illustration of a Customer's Net Equity Satisfied From a SIPC Advance Followed by a Distribution of Customer Property

If a trustee were able to collect all customer property immediately and distribute it to customers before SIPC advanced any funds for customers, then SIPC would never share as subrogee in customer property under SIPA §78fff-2(c)(1)(C) because no customer property would remain for distribution to

it. However, because, in reality, the collection of customer property takes time, SIPC may advance funds to a trustee for customers even when the amount of customer property is unknown. See SIPA §78fff-2(b)(1). Under SIPA, customers do not have to wait to have their claims satisfied while the trustee collects customer property, even if ultimately, there would have been enough customer property to make customers whole without the use of SIPC funds. Once the customer is fully satisfied, SIPC is subrogated to the customer's claim against customer property. As illustrated below, whether or not customers are first satisfied with funds from SIPC, the result is the same.

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

Customer	Customer's Net Equity	SIPC Advance	No Customer Property Collected Yet	Total Received By Customer	Amount Still Owed
A	$500K	$500K	$0	$500K	$0
B	$3.5 mill.	$500K	$0	$500K	$3 mill.

If the trustee eventually collects $2 million, $250,000, which would have been A's pro rata share, will be distributed to SIPC in reimbursement of its advance for A because A has been fully satisfied. The remaining $1.75 million will be distributed to B, as its pro rata share of customer property, and leaving B still owed $1.25 million. Thus, whether the SIPC advance is made before or after customer property is distributed, the outcome is the same.

Scenario 3: An Illustration of the Impact of "Net Equity" on the Distribution of Customer Property

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

Assume that the brokerage is BLMIS and that while BLMIS is in business, Investor A deposits $2 million with the firm. Over time, the account "grows" to $4 million so that it includes the initial $2 million deposit and an additional $2 million of fake profit. Assume that A decides to withdraw $2 million from his account on the day that Investor B opens an account with $2 million. BLMIS does not have the money to pay A his withdrawal and therefore, gives B's money to A. BLMIS is placed in liquidation shortly after B opens his account and

after he has received a fictitious statement showing fake securities positions in his account. Investors A and B both file claims for the amounts shown on their last account statements: A for the $2 million in securities that he believes is still in his account but actually has been "paid for" with fake profit, and B for the $2 million in securities that represents the $2 million that he deposited with BLMIS.

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

Trustee's Approach:

Customer	Customer's Net Equity	Pro Rata Share of Customer Property	SIPC Advance	Total Received by Customer	Amount Still Owed Customer
A	$0	$0	$0	$0	$0
B	$2 mill.	$1 mill.	$500K	$1.5 mill.	$500K

<u>Fictitious Statement Approach</u>:

Customer	Customer's Net Equity	<u>Pro Rata</u> Share of Customer Property	SIPC Advance	Total Received by Customer	Amount Still Owed to Customer
A	$2 mill.	$500K	$500K	$1 mill.	$1 mill.
B	$2 mill.	$500K	$500K	$1 mill.	$1 mill.

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

Under the fictitious statement approach, B would have recovered nothing while BLMIS was in business, having made no withdrawals from his account and having had his money given to A by BLMIS. In liquidation, B would recover $500,000 of customer property and $500,000 from SIPC for a total of $1 million on his $2 million claim. $1 million would still be owed to him.

In contrast, under the Trustee's approach, A would recover nothing in the SIPA liquidation and B

would receive all of the customer property plus the SIPC advance, for a total of $1.5 million. B, who is the only party who is out-of-pocket, would recover $500,000 more under the Trustee's approach than under the fictitious statement approach. Likewise, under the Trustee's approach, the fake profits already received by A would not continue to grow whereas they would under the fictitious statement approach.

From this illustration, it is clear that every dollar received by A, who already has recaptured his initial investment and more, is one dollar less for B who has yet to recover his initial investment. Thus, even in liquidation, as he did while the firm was in business, A continues to receive B's money, to the detriment of B, under the fictitious statement approach. As the BLMIS Trustee already has collected more than $9 billion for customers, with a number of lawsuits pending in which he seeks to recover more, see www.madofftrustee.com, the calculation of net equity will have a genuine impact on the amount of customer property received by each customer including those investors who already recovered their principal and received sizeable sums of money belonging to others.

III. THE SECOND CIRCUIT'S DECISION COMPORTS WITH APPLICABLE LAW

The petition should be denied because the decision of the Second Circuit is fully consistent with applicable law.

A. Second Circuit Law

The Second Circuit has issued at least two significant decisions that are relevant to the case at hand. One of those decisions, New Times I, was discussed briefly above, and because of its importance, is examined in more detail below.

Customers with two kinds of claims were involved in New Times I. One group of customers received account statements indicating that the customers were invested in real mutual funds. Although the trades had not actually occurred, the account statements mirrored in all respects what would have happened had the transactions taken place. See New Times I, 371 F.3d at 74. Unlike the BLMIS case, no price manipulation was involved. The other group consisted of customers who gave money to the broker to invest in mutual funds that ultimately never existed, and whose account statements showed fake securities positions, artificial interest and fake dividend reinvestments. Id. at 74. The position of SIPC and the trustee in the case was that the first group of customers had claims for securities while the second group, whose securities never existed, had claims for cash. Id. at 74-75, 83.[5]

In resolving the issue of what the customers with claims for fictitious securities were owed, the Court applied a two-pronged analysis. First, in deciding

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

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

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

In reaching its decision, the Court in New Times I took note of the decision in another SIPA case, Theodore H. Focht, Trustee v. Tessie C. Athens (In re Old Naples Securities, Inc.), 311 B. R. 607 (M.D. Fla. 2002) ("Old Naples"). See 371 F.3d at 88. In

that case in which non-existent bonds were "sold" and other investors' money was used to pay previous investors, the District Court remarked as follows with respect to "net equity" and the claimants' assertion that fake interest should be allowed:

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

311 B. R. at 616-617.

Significantly, the Old Naples Court agreed with the analysis set forth in In re C. J. Wright & Co., 162 B. R. 597 (Bankr. M.D. Fla. 1993) ("C. J. Wright"). There, responding to the position of the claimants that they were entitled to the return of their principal as well as interest that they would have

earned if the debtor actually had bought certificates of deposit ("CD") for them and the CDs had matured, the Bankruptcy Court stated:

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

162 B. R. at 609-610.

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

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

Consistent with New Times I, the Trustee in this case deemed the customers to have claims for securities because the claimants received fictitious account statements indicating "securities" were in their accounts. However, following the precedent of New Times and other cases, the Trustee declined otherwise to give effect to the fictitious statements because although the names of the issuers of many of the securities were "real," the fictitious statements bore no relation to reality, the prices having been determined not by the securities markets but by Madoff, and the fake "profits" having been pre-determined by him.

B. SIPA Section 78fff-2(b)

The decision of the Second Circuit also is fully consistent with SIPA and rules thereunder. Under SIPA section 78fff-2(b), a trustee must satisfy customers' net equity claims "insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee." "Books and records" of a debtor are more than just account statements. See, e.g., SEC Rule 17a-3, 17 C.F.R. §240.17a-3 (2011) (specifying no fewer than twenty-two categories of "books and records" to be maintained by broker-dealers). See also 15 U.S.C. §78q. Furthermore, if the books and records are unreliable, the claimant still must prove the obligation "to the satisfaction of the trustee." In the BLMIS case, the books and records and other information showed that the trades were backdated and fictitious, that the profits were fictitious, that certain claimants withdrew more than they deposited into their accounts, and that "securities" "purchased" with fake sales proceeds in fact were never paid for by the customer. For the Trustee to ignore what the books and records showed and to satisfy net equity claims based solely upon fictitious account statements would violate SIPA §78fff-2(b).

IV. THE DECISION OF THE SECOND CIRCUIT IS CORRECT IN NOT ENDORSING SECURITIES LAW VIOLATIONS

A. SIPA As Part of the Securities Laws

Moreover, implicit in the two New Times decisions is the recognition that to give unquestioning effect to fictitious account statements is to rubber-stamp fraud and other bad acts of a broker and to allow investors to benefit from that wrongful conduct. In that vein, courts consistently have recognized that SIPA and rules promulgated thereunder "manifest a design to deny protection to transactions tainted by fraud." Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.), 263 B.R. 406, 435 (S.D.N.Y. 2001) ("Adler"). See Arford v. Miller (In re Stratton Oakmont, Inc.), 239 B.R. 698, 701-702 (S.D.N.Y. 1999), aff'd, 210 F.3d 420 (2d Cir. 2000); SEC v. S.J. Salmon & Co., 375 F. Supp. 867, 870-71 (S.D.N.Y. 1974); In re Adler, Coleman Clearing Corp., 198 B.R. 70, 75 (Bankr. S.D.N.Y. 1996). Where a claimant undertakes no market risk, and claims entitlement to cash or securities only because of a broker's fraud, no "customer" relief under SIPA is available. See, e.g., supra, New Times I and II; Adler, 263 B.R. at 435. One reason for this outcome is that SIPC's goal of customer protection must be carried out consistent with the securities laws since SIPA itself is a part of the securities laws.

Except as otherwise provided in SIPA, the provisions of the Securities Exchange Act of 1934, 15 U.S.C. §78a et seq. ("the 1934 Act"), apply as if SIPA were an amendment to, and a section of the 1934

Act. SIPA §78bbb. Moreover, as explicitly provided in SIPA, while a primary function of the statute is to provide some protection to investors, another central function is to reinforce the broker-dealer's financial responsibility requirements so that the securities laws are strengthened.[6] Cf., SEC v. Packer, Wilbur & Co., 498 F.2d 978, 985 (2d Cir. 1974) (purpose of SIPA is to strengthen market. Goal is not served by reimbursing from public funds one whose fraudulent activities have weakened it). In considering the Series 500 Rules, 17 C.F.R. §300.500 et seq., adopted by SIPC and relating to whether customers have claims for cash or securities and the inapplicability of those rules with respect to certain fraudulent and similar type transactions, the District Court in Adler, supra, 263 B.R. at 434-435, commented:

> [The broker's] extensive fraud has overarching significance and implications for the transactions that culminated in the Challenged Trades.... Contrary to Appellants' perceptions of these events, [the broker's] deeds cannot be ignored in assessing whether Appellants are entitled to enforce the Challenged Trades. While it is true that one of SIPA's primary objectives is to protect

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

> individual customers from financial hardship, the legislation also embodies parallel and complementary aims....
>
> * * * *
>
> The SIPC 500 Rules, promulgated in 1988, ... reflect these ends. They safeguard securities customers' legitimate claims to cash and securities held by the debtor in their accounts prior to filing date, and also manifest a design to deny protection to transactions tainted by fraud.

The petition should be denied because the decision of the Second Circuit is consistent with the legislative intent that the SIPA protection not be administered at the expense of undermining the securities laws. The District Court's decision in Adler contains an extensive analysis in this regard, and therefore is discussed in detail below.

B. Adler

In an appeal from a decision of the Bankruptcy Court, the District Court in Adler, discussed many of the grounds for refusing protection to an investor in a SIPA case involving fraudulent activity of a broker and artificial profits created by the broker. Almost all of the grounds apply with equal force here, underscoring the soundness of the Second Circuit's decision.

In Adler, the District Court denied "customer" protection to claimants whose broker reported to

them that it had sold at inflated, above-market prices, certain near worthless "house stocks" in their accounts. The house stocks, although of negligible value, were nonetheless actual securities issued by existing corporations. The broker then used the fictional proceeds from these "sales" to buy valuable "blue chip" securities for their accounts. See Adler, 263 B.R. at 421-22. In denying the claimants' claim for the "blue chip" securities, the Court explained, inter alia, that the "sales" of the "house stocks" were reported to claimants at prices far above those the claimants could have obtained had the stocks been sold in the open market, and that, had the sales actually occurred at those prices, claimants would not have had enough cash to buy the "blue chips" sought in the liquidation. See Adler, 263 B.R. at 430 ("[T]here was no real cash in the Claimants' accounts because the trades never settled and the proceeds yielded by the Challenged Sales of House Stock, even at the inflated prices manipulated by Hanover [the broker], were not enough to cover the cost of the Blue Chips"). The Court concluded that affording the claimants customer status under SIPA was impermissible, observing that it:

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

Adler, 263 B.R. at 434. The District Court relied on a few different grounds in arriving at its ruling, some of which are discussed below.

i. **The Broker as the Claimant's Agent**

In Adler, the District Court rejected the claimants' contention that they were entitled to "customer" status due to their lack of knowledge of the broker's fraud. The Court found that, as beneficiaries of their broker/agent's fraud, they were chargeable with the broker's actions and intent. See 263 B.R. at 453-58.

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

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

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

Likewise, in BLMIS, any acts, knowledge and intent of BLMIS as agent were imputed to each investor as principal and to the extent that any investor sought to benefit from the agent's fraud and price manipulation, the investor would be chargeable with the agent's actions, knowledge, and intent.

ii. Fraudulent Trades Are Unenforceable

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

V. THE DECISION OF THE SECOND CIRCUIT IS CONSISTENT WITH SIPA'S ROLE AS A BANKRUPTCY STATUTE

The holding of the Second Circuit that investors, no matter how innocent, cannot benefit from a broker's fraud is echoed in the SIPA trustee's avoidance powers. SIPA is not only a securities law, but it is a bankruptcy law. SIPA section 78fff(b) makes applicable to the liquidation, to the extent consistent with SIPA, all of the provisions of Title 11 that apply in a Chapter 7 case except for subchapters I and II of chapter 7. Relevant here is the authority given to the trustee under SIPA section 78fff-2(c)(3) to recapture, through avoidance actions, customer property transferred by the debtor.

See In re Park South Sec., LLC, 326 B. R. 505, 512-513 (Bankr. S.D.N.Y. 2005).

As the District Court in Adler noted, the avoidance powers are critical to an important objective of both ordinary bankruptcy and SIPA liquidations, namely, maximizing recovery for ratable distribution to all customers. As the Court stated:

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

Adler, 263 B. R. at 463.

In Adler, the challenged trades were held avoidable as fraudulent transfers under the Bankruptcy Code ("Code") and state law made applicable under the Code. The same result was reached in the S. J. Salmon & Co., Inc. ("Salmon") SIPA liquidation proceeding. At issue there were trades that the trustee alleged were neither bona fide nor the result of arm's length transactions in the open market, but recorded only on the books and records of the brokerage in order to improve the

position of certain preferred customers in the face of the imminent liquidation of the firm. In ruling in favor of the trustee, the Court concluded that the "trades" were transfers made with actual intent to defraud creditors, a deliberate attempt to defraud SIPC under SIPA, and done "without fair consideration." The Court also noted that the true value of the trades was "not the prices quoted on that date, but rather the quotations published by dealers after debtor's cessation of business...," and that the "artificially high prices would vanish when [the broker] ceased acting as a market maker." SIPC v. S. J. Salmon, No. 72 Civ. 560, 1973 U.S. Dist. LEXIS 15606, at *19, *20 (S.D.N.Y. Aug. 8, 1973). Significantly, the Court also remarked:

> But SIPA was not intended to make the fraudulent transfer provisions of the Bankruptcy Act inoperative as to stockbroker-debtors in SIPA proceedings. While SIPA was intended to protect customers there is nothing in its provisions to indicate that less preferred creditors are to be denied the protection of the provisions which bar a debtor from making fraudulent transfers at their expense.

Id. at *31. See Gowan v. The Patriot Grp., LLC (In re Dreier LLP), 452 B.R. 391, 439-40 (Bankr. S.D.N.Y. 2011) (holding that chapter 11 trustee's suit for recovery of fictitious profits as fraudulent transfers could proceed because defendants did not provide reasonably equivalent value for the transfers); Sender v. Buchanan (In re Hedged-Investments Assoc., Inc.), 84 F.3d 1286, 1290 (10th

Cir. 1996) (allowing a trustee to bring a fraudulent transfer suit against a Ponzi scheme investor who withdrew more than she deposited).

VI. THE SECOND CIRCUIT DECISION IS CONSISTENT WITH EQUITABLE TREATMENT OF CUSTOMERS

As noted above by the Adler Court, a guiding principle of bankruptcy and SIPA law is to ensure equal treatment of creditors, including customers, so that in the case of customers, every customer stands on an equal footing and no single customer benefits, at the expense of others, by transactions that are tainted by fraud. Adler, 263 B.R. at 463. The equitable nature of bankruptcy law is a rule of long standing. See, e.g., Kothe v. R.C. Taylor Trust, 280 U.S. 224, 227 (1929) ("[T]he broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt's estate"). In that vein, a purpose of bankruptcy law is to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done." Pepper v. Litton, 308 U. S. 295, 308 (1939). The bankruptcy laws should be applied so that "substance will not give way to form, [and] technical considerations will not prevent substantial justice from being done." Id. at 305.

As discussed above, SIPA draws heavily upon bankruptcy law, expressly incorporating into the statute provisions of the Bankruptcy Code. See SIPA §78fff(b). As under bankruptcy law, SIPA too is instilled with equitable principles. Thus, customers "share ratably" in customer property collected by the trustee "on the basis and to the

extent of their respective net equities." SIPA § 78fff-2(c)(1)(B). Indeed, in 1978, when amending SIPA, Congress reaffirmed that a purpose of SIPA is to treat similarly situated customers equally. See First Federal Savings & Loan Assoc. of Lincoln v. Bevill, Bresler & Schulman, Inc. (In re Bevill, Bresler & Schulman, Inc.), 59 B.R. 353, 359-66 (D.N.J.), appeal dismissed, 802 F.2d 445 (3d Cir. 1986).

In light of the foregoing, Petitioner's position of entitlement to fictitious profits is squarely at odds with the objectives, purposes, and provisions, of SIPA. As victimized as even the net winners, like the petitioner, may have been by BLMIS and Madoff, and as the Second Circuit correctly concluded, there is no relief for them under SIPA. As the Ninth Circuit observed in In re Brentwood Sec., Inc., 925 F.2d 325, 330 (9th Cir. 1991):

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

See SEC v. Packer, Wilbur & Co., supra, 498 F.2d at 983 ("SIPA was not designed to provide full protection to all victims of a brokerage collapse. Its purpose was to extend relief to certain classes of customers.")

CONCLUSION

For all of the aforementioned reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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