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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IN RE: BERNARD L. MADOFF INVESTMENT SECURITIES LLC

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

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, IN SUPPORT OF APPELLEE AND AFFIRMANCE OF THE ORDER OF THE BANKRUPTCY COURT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases **Page**

Statutes and Rules

TABLE OF AUTHORITIES (Continued)

Page

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission has an important role in administering the Securities Investor Protection Act of 1970 (SIPA). *In re New Times Securities Services, Inc.*, 371 F.3d 68, 76-77 (2d Cir. 2004). The Commission submits this brief as an *amicus curiae*, pursuant to Fed. R. App. P. 29(a), in order to address the determination of net equity claims under the factual circumstances presented by *In re Bernard L. Madoff Investment Securities LLC.* 1/

STATEMENT OF THE ISSUE ON APPEAL

Customers of a brokerage firm deposited money to purchase securities pursuant to a trading program that was fraudulent. Although the customers received account statements from the firm showing securities positions purportedly effected pursuant to the program, those positions had been fabricated to achieve pre-determined results that could not have been achieved through actual trading in the securities markets.

1/ The Commission is submitting this brief as *amicus curiae* in accordance with the procedures of the ECF filing system. Under Section 5(c) of SIPA, however, the Commission may "file notice of its appearance in any proceeding under the Act and may thereafter participate as a party." 15 U.S.C. 78eee(c)

The question presented is: Should the customers' claims in the firm's liquidation proceeding under the Securities Investor Protection Act be based on the amount of money they deposited with the firm, less any money they withdrew, and not on the fictitious securities positions shown on the last account statements they received from the firm before it failed.

STATEMENT OF THE CASE

This is an appeal from an Order of the United States Bankruptcy Court for the Southern District of New York (Lifland, J.), dated March 8, 2010, in the liquidation proceeding of Bernard L. Madoff Investment Securities LLC (BLMIS) under the Securities Investor Protection Act of 1970 (SIPA). The Order implements a Memorandum Decision issued on March 1, 2010, in which the bankruptcy court held that customers' claims for the net equity in their accounts should be determined on the basis of the amount of cash deposited less any amount withdrawn. *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC)*, 424 B.R. 122 (Bankr. S.D.N.Y. 2010).

STATEMENT OF FACTS

A. The SIPA Proceeding

BLMIS was a securities broker-dealer registered with the Commission and a member of the Securities Investor Protection Corporation (SIPC). The

customers of BLMIS deposited money with the firm that they were told would be invested in securities pursuant to what the firm's principal, Bernard L. Madoff, called his "split-strike conversion strategy." SPA-19 (Special Appendix).

Although the customers received confirmations "documenting" securities transactions implementing this strategy and monthly statements listing the securities positions "held" for the customers' accounts, the money the customers deposited was never invested in securities for their accounts. SPA-22. The trades shown on the confirmations and monthly statements had been created by selecting prices from previously reported trading data that would produce returns for Madoff's "strategy" ranging from 10% to 17% annually. SPA-20. Such consistent returns over an extended period could not have been achieved through actual trading in the securities markets. SPA-16.

Madoff was operating a Ponzi scheme. Instead of making the investments, he used the money to pay customers who requested withdrawals from their accounts and for his own purposes. SPA-16. After his fraudulent scheme collapsed in early December 2008, BLMIS was placed in liquidation under SIPA.

The appellants and other customers filed claims with the trustee appointed to liquidate the firm, seeking payments for the net equity in their accounts based upon the securities positions shown on their account statements dated November

30, 2008, the last statements they received from BLMIS before it failed (the Last Statement Method). The trustee rejected claims for amounts based on the account statements, and instead based the claims determinations on the money the customers deposited with BLMIS less any withdrawals (the Net Investment Method).

The appellants and other customers filed objections to the trustee's determinations with the bankruptcy court.

B. Prior Commission Involvement

The Commission filed a brief in the bankruptcy court agreeing generally with the trustee that under the facts of this case net equity should be determined by the Net Investment Method, but noting that the amount of the payment should be calculated in constant dollars by adjusting for the effects of inflation. *In re New Times Sec. Servs.*, No. 08-1789, Dkt. 1052 (EOD 12/11/2009). This method of calculation treats all investors fairly by taking into account the economic reality that a dollar invested in 2008 has less value than a dollar invested many years earlier. 2/

2/ The bankruptcy court's decision was limited to whether net equity claims should be based on the Net Investment Method or the Last Statement Method. Other issues pertaining to claims determinations will be decided at a later time.

C. The Decision Below

The bankruptcy court ruled that the net equity claims of the BLMIS customers should be determined based on the Net Investment Method and not on the Last Statement Method. SPA-11-12.

The court rejected the claimants' view that account statements are the best evidence of the securities positions held in their accounts for purposes of the net equity calculation. SPA-27. Instead, the court ruled that net equity must be determined in accordance with SIPA Section 8(b), 15 U.S.C. 78fff-2(b), which requires that the trustee discharge 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." SPA-28. The court concluded:

> The BLMIS books and records expose a Ponzi scheme where no securities were ever ordered, paid for or acquired. Because "securities positions" are in fact nonexistent, the Trustee cannot discharge claims upon the false premise that customers' securities positions are what the account statements purport them to be. Rather, the only verifiable amounts that are manifest from the books and records are the cash deposits and withdrawals. *Id.*

The bankruptcy court also rejected the claimants' interpretation of this Court's decision in *In re New Times Securities Services, Inc.*, 371 F.3d 68 (2d Cir. 2004). The claimants argued that they are like the *New Times* customers who deposited money to purchase real securities and were allowed claims based on the

value of the securities on the filing date, consistent with what was shown on their account statements. SPA-34. The court rejected this analogy and held that they are like the customers in *New Times* who gave money to the broker to purchase fake securities and were allowed claims based on the amounts they invested less withdrawals. SPA-35. The court concluded:

> Analogous to the account statements of the Fake Securities Claimants, the BLMIS account statements "have no relation to reality." *New Times I*, 371 F.3d at 88. Although the securities that Madoff allegedly purchased were identifiable in name, the securities positions reflected on customer account statements were artificially constructed. By backdating trades to produce predetermined, favorable returns, Madoff, like the fraudster in *New Times*, essentially pulled the fictitious amounts from thin air. *Id.*

SUMMARY OF THE ARGUMENT

The trustee is required by Section 8(b) of SIPA to ascertain BLMIS's obligations to customers for the net equity in their accounts based on the firm's books and records or through other evidence satisfactory to the trustee. The books and records and other evidence showed that no securities were purchased for the accounts, that the securities positions shown on the account statements BLMIS sent its customers had been fabricated, and that the only activity in the customer accounts was the deposit and withdrawal of cash. Because the account statements and confirmations reflected earnings from a fraudulent scheme, they

cannot provide a basis for the trustee's determination of the firm's net equity obligations to customers. Instead, the net equity in a customer's account is the cash balance, less any amounts the customer owes to the firm.

The BLMIS customers' situation is analogous to the situation of the customers in *New Times* who were induced to purchase fictitious securities. In both situations, the securities positions on the account statements reflected fictitious profits that could not have been earned in actual trading in the securities markets. This Court, consistent with its analysis in *New Times*, should affirm the bankruptcy court's decision basing net equity on the Net Investment Method, not on the Last Statement Method.

ARGUMENT

Madoff's fraudulent investment scheme caused unprecedented losses to many innocent investors who believed their accounts with BLMIS held the securities shown on their account statements. Appellants argue that under SIPA the customers of BLMIS are entitled to receive either the securities listed on their statements or payments equal to the value of those securities on the filing date of the SIPA proceeding. SIPA, however, does not allow claims that include earnings from a fraudulent investment scheme. Under these circumstances, SIPA

and this Court's decisions in *New Times* require that the customers' net equity claims be determined by the Net Investment Method.

I. THE NET INVESTMENT METHOD IS REQUIRED BY SIPA.

The purpose of SIPA is to assure that customers get back the securities and cash that should be in their accounts when a brokerage firm fails. H.R. Rep. No. 91-1613, at 1 (1970); *SEC v. S.J. Salmon & Co., Inc.*, 375 F. Supp. 867, 871 (S.D.N.Y. 1974) ("[T]his statutory scheme was designed to facilitate the return of the property of customers of insolvent brokerage firms or, where this cannot be done, to reimburse such customers if their property has been lost or misappropriated.").

Customers file claims with the trustee appointed to liquidate the firm. SIPA Section 8(a)(2), 15 U.S.C. 78fff-2(a)(2). After receipt of a claim, the trustee must "promptly discharge ... all obligations of the debtor to a customer relating to, or net equity claims based upon, securities or cash ... insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee." SIPA Section 8(b), 15 U.S.C. 78fff-2(b).

Most customer claims in SIPA proceedings are for net equity, which is the dollar amount of the account, determined by calculating the liquidation value of

securities positions on the filing date of the SIPA proceeding, plus any cash held for the customer, and subtracting any amounts the customer owes the brokerage firm. SIPA Section 16(11), 15 U.S.C. 78*lll*(11). 3/ Customers share *pro rata* in customer property held by the firm based upon their net equity claims, receiving payments from the SIPC Fund for up to $500,000 (limited to $100,000 for cash) if customer property is insufficient to satisfy their claims. SIPA Section 9(a), 15 U.S.C. 78fff-3(a).

The appellants contend that because the last account statements are representations by BLMIS to them of the securities positions in their accounts, the statements determine what the firm owes them for purposes of their net equity claims. 4/ As explained in the following section discussing this Court's *New*

3/ *See SEC v. Aberdeen Sec. Co., Inc.*, 480 F.2d 1121, 1127 (3d Cir. 1973) ("[Section 16(11)] does not make it crystal clear that the customer's net equity consists of both his cash balance and the securities account valued as of the filing date. We have no doubt, however, that the 'dollar amount' of a customer's account includes his cash which the broker has, or should have, been holding.").

4/ Brief for Appellants Michael Schur and Edith A. Schur, at 20 ("on a liquidation of a BLMIS customer's account, that customer would clearly have been entitled to receive from BLMIS the securities that BLMIS represented were contained in the account and/or the full value reflected in the final customer account statement"), Joint Brief for Appellants, at 22 ("Judge Lifland misinterpreted [Section 8(b)] to mean that the debtor's secret 'books and records' showing illegal activity dictate customer claims

(continued...)

Times decisions, however, account statements showing securities positions that reflect fictitious profits that could not have been earned in actual securities market trading are not a basis for determining net equity obligations under SIPA.

As required by Section 8(b), the trustee must ascertain net equity obligations from the brokerage firm's books and records, or, because the books and records of a failing firm are often deficient, through other satisfactory evidence. The Trustee's examination of BLMIS's books and records, as well as records of clearing firms and exchanges, did not show any trades actually effected for the customers' accounts pursuant to the split-strike conversion strategy. Instead, the Trustee's examination established that the securities positions listed on the account statements were selected by BLMIS to achieve pre-determined earnings set by Madoff for his fraudulent strategy.

In sum, the Trustee was unable to base the claims determinations on the fraudulent securities positions shown on the account statements. He therefore based the determinations on the only activity that he could ascertain had occurred

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4/ (...continued)
amounts, rather than the representations BLMIS made to its customers through account statements and other communications."); Brief for Appellants Sterling Equities Associates, *et al.*, at 20 ("The [account] statements evidence BLMIS's obligation to them on the filing date. No further proof is required by [Section 8(b)] ... .").

in the accounts – the customers' deposits and withdrawals of cash. *See* SIPA Section 16(2), 15 U.S.C. 78*lll*(2) ("customer" means persons who have claims on account of securities or persons who have deposited cash with the debtor for the purchase of purchasing securities). The net equity in a customer's account in these circumstances is the cash balance less any amounts the customer owed to BLMIS. 5/

5/ Several appellants argue that they are entitled to the securities on their account statements under Section 8-501(b)(1) of the New York Uniform Commercial Code, which provides that "a person acquires a securities entitlement if a securities intermediary ... indicates by book entry that a financial asset has been credited to the person's security account." N.Y. U.C.C. § 8-501(b)(1). *E.g.*, Brief of Appellants Sterling Equities Associates, *et al.*, at 10-12; Joint Brief of Appellants, at 24 & n.15. They equate the phrase "book entry" in Section 8-501(b)(1) with the listing of securities positions on monthly account statements and the reporting of transactions on confirmations. *See id.* at 11; Brief of Appellants Michael Schur and Edith A. Schur, at 21. This is incorrect.

Typically, brokers hold securities for customers in "street name," which means that the security is registered in the brokerage firm's name on the issuer's books; the firm holds the security for the customer in "book-entry" form, keeping a record in its books that the customer owns the particular security. U.S. Securities and Exchange Commission, "Holding Your Securities – Get the Facts," http://www.sec.gov/investor/pubs/holdsec.htm (last visited Sept. 12, 2010). Section 8-501 does not specify how a broker "indicates by book entry" that a particular securities position "has been credited to the person's security account." In accounting terminology, however, a "book of original entry" is a record book in which transactions are entered. KOHLER'S DICTIONARY FOR ACCOUNTANTS 70 (6TH ED. 1983) (defining "book of original entry" as "[a] record book, recognized by law or

(continued...)

II. THE NET INVESTMENT METHOD IS CONSISTENT WITH THIS COURT'S *NEW TIMES* DECISIONS.

SIPA is intended to assure that customers receive the securities and cash that should be in their accounts when a firm fails, but it does not give them claims that include fictitious profits from a fraudulent trading scheme. *See In re MV Sec., Inc.*, 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985). Thus, SIPA covers claims of customers who deposit cash with a broker for the purpose of purchasing securities, but the broker never makes the purchases. In this situation, the trustee typically satisfies claims by giving customers the filing date value of the securities that should have been purchased for their accounts. 6/ This remedy is

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5/ (...continued)
custom, in which transactions are successively recorded, and which is the source of postings to ledgers; a journal"); *id.* at 295 (defining "journal entry" as "[a]n item in or prepared for a book of original entry, interpreting a business transaction in bookkeeping terms and showing the accounts to be debited and credited"). Account statements and confirmations sent to customers are not books used by brokerage firms to make entries crediting and debiting customer accounts with securities transactions.

6/ *See* Joint Appendix, Vol. III, A-56 (testimony at bankruptcy court hearing in *New Times* proceeding given by SIPC General Counsel (now President) Stephen P. Harbeck, explaining that customers who are led by their brokerage firms to believe that securities have been purchased for their accounts, when in fact the securities are never purchased, are entitled to the full value of the securities positions on the filing date).

not appropriate, however, where the broker promises to invest a customer's money in what is in fact a fraudulent trading scheme.

The difference is illustrated by this Court's decisions in *In re New Times Securities Services, Inc.*, 371 F.3d 68 (2d Cir. 2004) (*New Times I*), and *Stafford v. Giddens (In re New Times Securities Services, Inc.)*, 463 F.3d 125 (2d Cir. 2006) (*New Times II)*. The *New Times* decisions involved a Ponzi scheme in which certain customers were solicited to invest in money market funds that existed (the "Vanguard/Putnam investors") and others were solicited to invest in a non-existent money market fund (the "New Age investors"). The customers' money was never invested, but was converted by the firm's principal. *New Times I*, 371 F.3d at 71-72.

The trustee in *New Times* determined the claims of the Vanguard/Putnam investors by giving them the real securities that should have been purchased for their accounts, consistent with their account statements, which "'mirrored what would have happened had the given transaction been executed.'" *New Times I*, 371 F.3d at 74 (quoting joint brief filed by trustee and SIPC). In contrast, the trustee determined the claims of the New Age investors by giving them the money they had invested less any money they had withdrawn, not including the fictitious "interest" shown on their account statements. *Id.*

This Court agreed with the trustee's determination of the New Age investors' claims, stating 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 ... .'" *New Times I*, 371 F.3d at 88 (quoting *amicus curiae* brief of Securities and Exchange Commission). In *New Times II*, the Court elaborated on the reasoning of *New Times I*, explaining that valuing claims based on non-existent securities would, in essence, require the trustee to treat an imaginary trading world as if it were real. 463 F.3d at 129-30.

Although the *New Times* decisions involved fictitious securities, rather than the fictitious securities trading program at issue here, the Commission believes that it would be similarly inappropriate to credit the fictitious paper profits reflected on the BLMIS customers' account statements. Instead, as with the New Age investors in non-existent securities, the calculation of net equity should be based upon the money the BLMIS customers invested less any amounts they withdrew.

The Commission disagrees with the appellants' view that, because the securities BLMIS purportedly purchased for them were not fictitious, but real, the trustee must calculate net equity based upon the securities positions reported on the account statements. Although the BLMIS customers' situation has some

similarity to the Vanguard/Putnam investors, who believed they were purchasing real money market fund securities, there is an important difference that dictates a different result.

The Vanguard/Putnam investors' claims could be satisfied with securities positions consistent with the account statements, which mirrored the actual performance of the Vanguard/Putnam securities. In contrast, the securities positions on the BLMIS account statements did not mirror actual trading in the securities markets. Instead, the positions reflected transactions purportedly executed at prices calibrated after the fact to produce predetermined favorable returns – returns that were possible only because they were divorced from the uncertainty and risk of actual market trading. Madoff was able to concoct the securities positions on the BLMIS statements only by opting out of the market in favor of the fictitious trading world of his scheme.

With respect to SIPA, there is no meaningful difference between "fraudulent promises made on fake securities" (*New Times II*, 463 F.3d at 130) and fraudulent promises involving positions in real securities that are fabricated through fictitious trades based on hindsight. Both situations involve "fictitious paper profits" (*id.*) that are not allowable claims under SIPA.

* * * * *

The bankruptcy court stated that, in addition to the *New Times* analysis, it was "persuaded by the reasoning in *Focht v. Athens (In re Old Naples Sec., Inc.)*" that claims in SIPA cases involving Ponzi schemes should be decided the same way as claims in non-SIPA cases involving Ponzi schemes – *i.e.*, limited to the actual principal amount invested less payments received. *In re BLMIS*, 424 B.R. at 140 n.35. The Commission disagrees with this alternative reasoning.

Customer claims in SIPA cases must be determined in accordance with the provisions of SIPA, not by principles courts apply in resolving claims of Ponzi scheme victims. Indeed, this is illustrated by *New Times*, which also involved a Ponzi scheme. The Vanguard/Putnam investors were allowed net equity claims based on the filing date value of the securities that should have been purchased for them (including any earnings up to that date), and were not limited to the actual principal amounts they invested less any payments they received.

SIPA is a product of Congressional concern that customers of failed brokerage firms receive the assets that should be in their accounts when the firm is placed in liquidation. While customers in Ponzi schemes generally may be limited to a return of their actual initial principal amounts less amounts withdrawn, customers in SIPA liquidations have claims for the net equity in their accounts.

In addition, limiting net equity claims in a SIPA case to the actual amount invested could preclude calculation of the claim in constant dollars, which the Commission believes is the appropriate method of determining net equity in this case. Although investors should not be entitled to distributions based upon fraudulent profits, claims for net equity in a case under SIPA that involves a Ponzi scheme are not limited to the actual dollar amount a customer invested, but should be calculated in constant dollar terms in order to account for inflation during the time the customer's money is held by the firm. Under the circumstances of this case, this remedy best effectuates SIPA's purpose of assuring that customers receive the assets that should be in their accounts when a brokerage firm fails.

CONCLUSION

The bankruptcy court correctly determined that the BLMIS customers' net equity claims should be based on the Net Investment Method. The order of the bankruptcy court should therefore be affirmed.

Respectfully submitted,

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September 2010

CERTIFICATE OF COMPLIANCE

I hereby certify that this brief complies with the type-volume limitations of Fed. R. App. P. 32(a)(7)(B) because this brief contains 3,820 words, excluding the Table of Contents, Table of Authorities, Certificate of Compliance, and Certificate of Service.

I also certify that this brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using WordPerfect 11 in 14-point Times New Roman type.

/s/ *Katharine B. Gresham*
KATHARINE B. GRESHAM
Securities and Exchange Commission
September 2010

CERTIFICATE OF SERVICE

I hereby certify that on September 21, 2010, I caused true and correct copies of the Brief of the Securities and Exchange Commission, *Amicus Curiae*, in support of Appellee and Affirmance of the Order of the Bankruptcy Court to be served upon the parties who receive electronic service in this proceeding through CM/ECF, and two copies to be served by prepaid overnight delivery upon Marshall W. Krause, Esq., P.O. Box 70, San Geronimo, CA 94963.

/s/ *Katharine B. Gresham*
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