- Where customers' statements reflected securities positions in closed mutual funds, "the Trustee properly gave the customers cash equal to the filing date values of the closed mutual funds." (Reply Mem. in Further Support of Trustee's Motion for Order Upholding Determinations at 20, *SEC v. Goren*, 206 F. Supp. 2d 344 (E.D.N.Y. 2002) (No. 00-CV-970));

- "In those cases [that concern the payment of interest/dividends on bona fide mutual funds] the claimants had an objectively legitimate expectation of receiving interest/dividends *because the security in question had actually earned them.* Here, the bogus mutual fund [the Fictitious New Age Fund] was never organized as a mutual fund and had no assets or investments."[12] (Br. for Appellants James W. Giddens as Trustee for the Liquidation of the Businesses of New Times Securities Services, Inc. and New Age Financial Services, Inc. and Securities Investor Protection Corporation ("Br. for New Times Trustee and SIPC") at 38, *New Times I* (No. 02-6166) (emphasis added)).

The New Times Trustee, SIPC and the SEC were not alone in their view that SIPA provides that "real" securities claimants have "net equity" claims based on the value of their "securities positions" as of the filing date, notwithstanding that those securities had never been purchased by the broker-dealer. Two separate panels of the Second Circuit have also considered this issue in the context of the New Times liquidation and similarly endorsed according "real" securities claimants more favorable treatment than "fictitious" securities claimants.

New Times I involved two basic issues: (1) should "fictitious" securities claimants be treated as (a) "cash" claimants who could receive a maximum of up to $100,000 in SIPC advances, or (b) "securities" claimants who could receive up

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[12] SIPC and the New Times Trustee also valued claims by "Real Securities" customers in accordance with SIPA's definition of "net equity," even when those claims included mutual fund shares purportedly purchased through "dividend reinvestments," notwithstanding that no such purchases had, in fact, taken place (precisely because there had not, in fact, been any "dividends" to "reinvest"):

- "[I]nvestors who believed that their accounts held shares of mutual funds that actually existed (but were never purchased for their accounts) are having their claims (both as to shares of mutual funds never purchased by Goren *and shares shown in customer statements as purchased through dividend reinvestment*) satisfied by the Trustee up to the statutory maximum of $500,000." (Claimants' Joint Mem. of Law in Opposition to Joint Motion of Trustee and SIPC for Order Upholding Determinations at 3, *SEC v. Goren*, 206 F. Supp. 2d 344 (E.D.N.Y. 2002) (No. 00-CV-970) (emphasis added)).

- "[W]hereas the Trustee has disallowed that portion of the claim of [the Fictitious New Age Funds] investors representing shares of [the Fictitious New Age Funds] purchased through dividend reinvestment, *the Trustee has allowed that portion of the mutual fund investors' claims [i.e., "Real Securities" investors' claims] as represents shares of such mutual funds purchased by them through dividend reinvestment.*" (Limited Objection [of Myrna K. Jacobs] to Trustee's Determination of Claim at 6 n.4, *SEC v. Goren*, 206 F. Supp. 2d 344 (E.D.N.Y. 2002) (No. 00-CV-970) (emphasis added)).

to $500,000 in SIPC advances; and (2) how should "fictitious" securities claimants' (*not* "real" securities claimants') "net equity" be calculated. Before answering these two questions, the court took note of the disparate treatment the Trustee had afforded the "real" and "fictitious" securities claimants, and why he had done so:

> "Meanwhile, investors who were misled by Goren to believe that they were investing in mutual funds that in reality existed were treated much more favorably. Although they were not actually invested in those real funds – because Goren never executed the transactions – the information that these claimants received on their account statements 'mirrored what would have happened had the given transaction been executed.' [Br. for New Times Trustee and SIPC] at 7 n.6. As a result, the Trustee deemed those customers' claims to be 'securities claims' eligible to receive up to $500,000 in SIPC advances. *Id.* The Trustee indicates that this disparate treatment was justified because he could purchase real, existing securities to satisfy such securities claims. *Id.* Furthermore, the Trustee notes that, if they were checking on their mutual funds, the 'securities claimants,' in contrast to the 'cash claimants' bringing this appeal, could have confirmed the existence of those funds and tracked the funds' performance against Goren's account statements. *Id.*"

New Times I, 371 F.3d at 74.

Ultimately, the court concluded, with the benefit of the SEC's views, that (1) a customer's "legitimate expectations," as evidenced by the written confirmations she receives, are paramount, and therefore the "fictitious" securities claimants should have been treated as "securities" claimants who could recover up to $500,000 in SIPC advances, but that (2) "fictitious" securities – which were non-existent and therefore had no publicly verifiable market value and could not be purchased anywhere – would have to be valued simply based on the amount of money those "fictitious" securities customers had initially provided to the debtor.

As to the first conclusion, the Second Circuit agreed with the SEC that it is a customer's legitimate expectations based on written confirmations and account statements that control how a net equity claim is determined. In doing so, the court considered, *inter alia*, SIPC's Series 500 Rules, 17 C.F.R. §§ 300.500-300.503, which were promulgated by SIPC and approved by the SEC, and which confirm the critical importance of written confirmations. The court explained that "the premise underlying the Series 500 Rules [is] that a customer's 'legitimate expectations,' based on written confirmations of transactions, ought to be protected." *New Times I*, 371 F.3d at 87. Although not determinative of the issue facing the court, it nonetheless found the Rules supportive of and consistent with its holding because, "[u]nder the Series 500 Rules, whether a claim is treated as one for securities or cash depends not on what is *actually* in the customer's account but on what the customer has been told by the debtor in written

confirmations." *Id.* at 86 (emphasis in original). *See also In re Oberweis Sec., Inc.*, 135 B.R. 842, 847 n.1 (Bankr. N.D. Ill. 1991) ("The court agrees with the trustee's argument that Congress did not intend to treat customers without confirmations [in a SIPA liquidation] the same as those with confirmations; that customers with confirmations have a legitimate expectation of receiving securities, but customers without confirmations do not have the same expectation.").

With respect to the valuation question, the SEC argued to the Second Circuit that the "net equity" of "fictitious" securities claimants should equal the amount of money invested minus any withdrawals, reasoning that, although "net equity" is equal to the sum that the debtor would have owed the customer had the customer liquidated his or her securities positions on the filing date, "a *fictitious* security cannot be 'liquidated.'" SEC Amicus Curiae Brief at 15 (emphasis added). Accordingly, the values ascribed to such "fictitious" securities on customers' account statements would "necessarily have no relation to reality" because they would be merely "subject to the whim of the broker-dealer who makes up fictitious values for securities and dividends." *Id.* at 16-17. The Second Circuit agreed, finding 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 SEC Amicus Curiae Brief at 16).

In short, under *New Times I*, it is only where the "securities positions" reflected on the confirmations and account statements have "no relation to reality" – because they are not objectively and publicly verifiable or capable of replacement – that a "cash in, cash out" valuation methodology is the only reasonable proxy for that customer's legitimate expectations. That is obviously not the situation for Madoff customers.

Two years later, a different Second Circuit panel considered related issues in the New Times liquidation and expressed the very same views regarding the importance under SIPA of meeting a customer's legitimate expectations. *In re New Times Sec. Servs., Inc.*, 463 F.3d 125, 128 (2d Cir. 2006) ("*New Times II*") ("It is a customer's legitimate expectations on the filing date . . . that determines the availability, nature, and extent of customer relief under SIPA."). *New Times II* concerned claim determination objections brought by purchasers of a third type of instrument sold by Goren: fraudulent promissory notes. Those promissory note purchasers were challenging the trustee's position that, as noteholders, they did not qualify as "customers" under SIPA. Of particular relevance to the Madoff case is SIPC's repeated statement that customers' legitimate expectations control even when no securities were ever purchased:

> "[R]easonable and legitimate claimant expectations on the filing date are controlling even where inconsistent with transactional reality. Thus, for example, where a claimant orders a securities purchase and receives a written confirmation statement reflecting that purchase, the claimant generally has a reasonable expectation

> that he or she holds the securities identified in the confirmation and therefore generally is entitled to recover those securities (within the limits imposed by SIPA), *even where the purchase never actually occurred and the debtor instead converted the cash deposited by the claimant to fund that purchase*. . . . [T]his emphasis on reasonable and legitimate claimant expectations frequently yields much greater 'customer' protection than would be the case if transactional reality, not claimant expectations, were controlling, as this Court's earlier opinion in this liquidation well illustrates."

Br. of Appellant SIPC at 23-24 (citing *New Times I*) (emphasis added), *New Times II*, (No. 05-5527).

As the court in *New Times II* explained, it is only in the context of "fictitious" securities claims that the "cash in, cash out" valuation methodology makes sense:

> "*Because there were no such securities*, and it was therefore impossible to reimburse customers with the actual securities or their market value on the filing date (the usual remedies when customers hold specific securities), the [*New Times I* Court] determined that the securities should be valued according to the amount of the initial investment. 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. . . . The court looked to the initial investment as the measure for reimbursement because the initial investment amount was the best proxy for the customers' legitimate expectations."

New Times II, 463 F.3d at 129-30 (citations omitted)(emphasis added).

The "cash in, cash out" valuation methodology employed in *New Times I* with respect to "fictitious" securities claimants has no place in the Madoff case, where customers' confirmations and account statements reflected "real," well-known and publicly verifiable securities. Because the prices and values ascribed to the "securities positions" on those records "mirrored what would have happened had the given transaction been executed," Br. for New Times Trustee and SIPC at 7 n.6, the liquidation filing date value of those "securities positions" is the "best proxy for the customers' legitimate expectations." *New Times II*, 463 F.3d at 130.

The Madoff investors are no different than the "Real Securities" investors in *New Times I*. They received written trade confirmations and monthly account statements that reflected "security positions" for securities that actually existed, and the names and prices of those securities, as reflected on the confirmations and

account statements, were verifiable based on publicly available information. Because they had legitimate expectations that their accounts held bona fide securities, and were earning profits on those bona fide securities, they should be treated just as the "Real Securities" claimants were in *New Times I.*

4. The Trustee's Position Would Materially Erode Investor Confidence

If accepted, the Trustee's interpretation of "net equity" would have significant and far-reaching negative implications well beyond the Madoff proceeding. For the last forty years, individual and institutional securities investors have placed great reliance on a host of statutory and regulatory safeguards. The protections afforded by SIPA and SIPC have been near or at the top of those safeguards since 1970. Acceptance of the Trustee's rejection of SIPA in the Madoff case would not go unnoticed. To the contrary, it would necessarily and materially erode investor confidence in the SIPA regulatory regime, and, as a result, the securities markets and industry as a whole. It would also very likely lead to concerned broker-dealer customers employing a variety of inventive and potentially troublesome techniques to game the system and engage in various self-help efforts to maintain at least some SIPC protection for their accounts. Such actions would be extremely disruptive to the customer and harmful to the securities industry, and would serve no purpose other than to attempt to get around a lawless precedent that would have been set by the Trustee in this case.

For example, if customers are informed that, contrary to SIPA, SIPC may well calculate their "net equity" on a "cash in, cash out" basis, many could decide that they have to take steps on their own to enhance whatever protection they might be entitled to. To the extent they have not been chilled entirely from investing, many could conclude that as soon as their "cash out" level comes within $500,000 of their "cash in" level, they should close their accounts and transfer their holdings to a new broker-dealer.[13] It would only be through that type of convoluted process – wherein the customers are, in effect, hitting the "reset button" – that brokerage customers can believe that they have done what they could to try to salvage at least some of the protection they had thought they were being afforded when SIPA was enacted. We should not need to describe the havoc that such actions would play on the securities industry and markets.

A short example may be helpful to illustrate this concern. Consider a customer with a brokerage account having the following characteristics:

- she opened the account 20 years ago with a $500,000 deposit (and this is the only deposit she ever made into the account);

[13] Smaller-scale customers, whose accounts are worth less than $500,000, may have even more complicated concerns. Those customers will know that every dollar they withdraw – starting with the very first such dollar – will potentially reduce their SIPC protection. As a result, such customers may either decide not to invest at all (because the protection scheme is so complicated and, it turns out, weak), or try to devise some method for spreading their investment activity amongst multiple brokers and/or opening and closing accounts on a regular basis.

- the broker purportedly purchases "real" securities such as IBM, etc.;
- over the life of the account, each year she withdraws anywhere from $25,000 to $50,000 in order to:

  (a) pay taxes on the profits reported on the account, and

  (b) pay living expenses;
- the broker never in fact purchased any securities because he was operating a ponzi scheme; and
- by the time the broker's ponzi scheme is uncovered, the value of the investor's "securities positions" as reflected in the written confirmations and account statements she received – and which were verifiable through publicly available information – had grown to $2,000,000.

According to the Trustee's position, because over the life of the account the customer had withdrawn more than she had deposited, she would have no "net equity" claim and would not be entitled to anything from the SIPC fund. According to SIPA, she would have a "net equity" claim of $2,000,000, thus entitling her to $500,000 from the SIPC fund, as well as her pro rata share of any customer property collected by the trustee. Clearly, if the Trustee's position is upheld, customers such as this hypothetical one would be far better off by closing accounts and switching brokers on a regular basis.

Finally, the Trustee's net equity position would not only provide no compensation to customers who had withdrawn more money than they had deposited, but it would also significantly disadvantage customers who had never taken anything out of their account. Thus, for example, a customer who deposited $100,000, never withdrew anything, and received account statements showing her investment had grown to $400,000 would be made whole under SIPA, but would only receive $100,000 under the Trustee's "net equity" view.

Although the Trustee's approach would undoubtedly result in much of the SIPC reserve fund remaining untapped and unavailable to thousands of Madoff victims, achieving such a result is not the purpose of SIPA and should not be the purpose of the Trustee. To the contrary, SIPA's and the Trustee's purposes are very simply to assist customers in realizing as closely as possible their legitimate expectations.

CONCLUSION

For the reasons set forth above, we urge the SEC to exercise its oversight authority in this matter, not only to ensure that SIPC discharges its obligations as it is required to under the law, but also to ensure that SIPA's purposes are furthered, Madoff customers' legitimate expectations are protected, and all securities investors' confidence in SIPC protection is maintained. Specifically,

we ask that the SEC (1) attempt to persuade the Trustee to follow SIPA, and (2) in the event that effort is unsuccessful, seek a court order requiring him to do so. *See* 15 U.S.C. § 78ggg(b) ("Enforcement of actions. In the event of the refusal of SIPC to commit its funds or otherwise to act for the protection of customers of any member of SIPC, the Commission may apply to the district court of the United States in which the principal office of SIPC is located for an order requiring SIPC to discharge its obligations under this Act and for such other relief as the court may deem appropriate to carry out the purposes of the Act.").

One final observation: It is not too late to correct the Trustee's error, but soon it will be. The bar date in this case is July 2, 2009. Claims not filed by then likely will never be allowed. The Trustee's numerous public and inaccurate assertions of what the law is with respect to whether Madoff customers have allowable "net equity" claims have undoubtedly influenced and will continue to influence thousands of customers in deciding (1) whether to file any claim at all, and (2) whether to settle their claims (if filed) in accordance with the Trustee's erroneous representation as to what they are entitled to (with the standard accompanying releases to such settlements precluding them from later recovering what they are actually entitled to). Thus, an ultimate court victory by private parties as a result of litigation on this issue will do such customers no good, because that victory will have been too late for them.

We very much appreciate your consideration of this critically important and time sensitive issue which – if resolved in accordance with SIPA – will have a materially positive impact on thousands of Madoff customers, as well as on the broader investing public and securities industry. We respectfully request the opportunity to meet with you and your colleagues at your earliest convenience to discuss this matter with you.

Respectfully,

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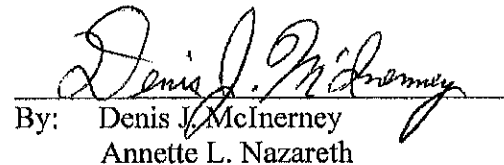

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(continued below)