In The Matter Of:

IN RE: BERNARD L. MADOFF
INVESTMENT SECURITIES LLC

U.S. COURT OF APPEALS - SECOND CIRCUIT
March 3, 2011

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
DOCKET NO. 10-2378

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In Re:

BERNARD L. MADOFF INVESTMENT   ORAL ARGUMENT
SECURITIES LLC.

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March 3, 2011, 11:06 a.m.

Moynihan U.S. Courthouse
Ceremonial Courtroom
500 Pearl Street
New York, New York 10007

B E F O R E:

HON. DENNIS JACOBS, Chief Judge
HON. PIERRE N. LEVAL
HON. REENA RAGGI

Reported by:

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25

1   JUDGE JACOBS: At this time we'll

2   hear In Re Bernard L. Madoff Investment Securities

3   LLC.

4   MR. LAX: If it may please the Court,

5   my name is Barry Lax of Lax & Neville. I'll be

6   arguing on behalf of the appellants for six minutes,

7   and then Karen Wagner of Davis Polk will argue eight

8   minutes, and we're going to reserve six minutes for

9   rebuttal by Ms. Chaitman.

10   JUDGE JACOBS: Are you going to divvy

11   up issues in any way?

12   MR. LAX: We're not really, Your

13   Honor.

14   JUDGE JACOBS: All right.

15   MR. LAX: Thank you very much.

16   This case can be decided by simple

17   statutory application. The issue before this Court

18   is how net equity should be determined under the

19   Securities Investor Protection Act, period. The

20   Bankruptcy Court misinterpreted the law and the

21   issue before it by significantly relying on the

22   size, nature and effects of an SEC-regulated

23   broker-dealer's fraud that caused its failure.

24   However, those factors are irrelevant under the

25   statute for the determination of net equity. Net

1 equity is determined by valuing the dollar amount of

2 the customer's account by calculating what would

3 have been owed by the broker had the customers'

4 securities positions been liquidated on the filing

5 date.

6   JUDGE JACOBS: Of course if the

7 positions had actually been liquidated on the filing

8 date, there would have been nothing there.

9   MR. LAX: I understand that, Your

10 Honor, but whether or not there are security

11 positions in a customer's account is irrelevant.

12 And that's what the statute says. The statute says

13 when there's no securities positions in a customer's

14 account, the Trustee is obligated to go into the

15 market to try to purchase those securities. And

16 that's what makes sense, to use a customer's account

17 statements. The customer account statement is the

18 beginning and the end of the inquiry.

19   JUDGE JACOBS: Let me give you a

20 hypothetical. Let's say that a customer invests

21 with a faithless fiduciary $10,000. Within a month,

22 wonderfully, it doubles. The broker takes half the

23 gains, $5,000, and spends it on wine and cigars.

24 And then the company goes bust. The account

25 statement would list only 15,000 and not 20,000.

1   Are you saying that under those circumstances the

2   customer would only be entitled to 15,000 because

3   that's what's on the account statement, fraudulently

4   worked up by the broker, or would the customer be

5   entitled to the full 20,000?

6   MR. LAX: The customer would be

7   entitled to the full 20,000 in that scenario.

8   JUDGE JACOBS: Okay, that's not

9   what's on the account statement. You just said the

10 account statement is the beginning and the end of

11 it.

12   MR. LAX: Well, the account statement

13 controls, Your Honor. But what you would have to do

14 is value what the broker owes the customer on the

15 filing date, so in your scenario that's what the

16 broker would owe the customer on the filing date.

17   JUDGE JACOBS: So, but that wouldn't

18 be determined by reference only to the account

19 statement.

20   MR. LAX: Well, when you can work

21 inside the statutory framework.

22   JUDGE JACOBS: Well, wouldn't you

23 have to look then at books and records and at the

24 market prices?

25   MR. LAX: Well, the account

1 statements and confirms are books and records.

2 They're actually the only books and records that

3 customers have access to and the only ones that are

4 delivered to customers.

5   JUDGE JACOBS: Yes, but in my

6 hypothetical you wouldn't rely on the account

7 statements, you would look behind them.

8   MR. LAX: There are certain

9 circumstances where you could look behind account

10 statements and confirms and that's what the statute

11 provides. But that's when the statutory framework

12 doesn't work, but the statutory framework works for

13 Madoff victims. Madoff victims received account

14 statements and confirms for the purchase of real

15 securities. And I'd like the Court to notice when

16 they do their -- when they render their decision, if

17 they look at volume 3, page 792 to 799, you'll

18 recognize all of the securities that are contained

19 on those customer account statements. It goes from

20 Wells Fargo to Wal-Mart to Merck to Microsoft to

21 Apple, all of these securities are going to be

22 completely known by the Court.

23   JUDGE RAGGI: Though none of these

24 were orders placed by the customers, if I understand

25 it, right? There was complete discretion as to what

1   would be purchased.

2   MR. LAX: But there is no difference,

3   Your Honor, between giving --

4   JUDGE RAGGI: But am I right in that

5   assumption?

6   MR. LAX: Correct, Your Honor, but

7   broker-dealers get discretion either when the

8   account's opened or midway through --

9   JUDGE RAGGI: To a large part the

10 basis for the bankruptcy judge's decision was the

11 determination that net equity has to be -- doesn't

12 bear a particular statutory definition, rather that

13 it's to be determined by looking to the totality of

14 the circumstances of the conduct that brings

15 everyone before the Court. And it was that

16 assumption that informed this choice. Is that a

17 flawed assumption or is it just that it was applied

18 incorrectly? I want to know where you think the

19 error originates.

20   MR. LAX: That's a flawed assumption,

21 Your Honor.

22   JUDGE RAGGI: Tell me why you think

23 so.

24   MR. LAX: Because there is no

25 exception for Ponzi schemes in the statute, there is

1 no exceptions for the size or the nature or the

2 effect.

3   JUDGE RAGGI: Nevertheless we saw

4 where the bankruptcy judge cited to portions of the

5 statute to support his conclusion that it was

6 appropriately viewed in the context of the

7 particular conduct at issue in the case.

8   MR. LAX: Well, I saw and that was

9 just error, Your Honor.

10   JUDGE RAGGI: Why?

11   MR. LAX: Because the statute doesn't

12 provide for any exceptions to those kinds of

13 considerations. Those factors are completely

14 irrelevant. The lone issue is can you follow the

15 definition of net equity, which this SIPC Trustee

16 could have. All he had to do was go into the market

17 and purchase those real securities, which he could

18 have.

19   JUDGE RAGGI: But the bankruptcy

20 judge cites to different hypotheticals that I assume

21 were supplied by the parties, but no matter. In

22 which what you're urging could yield absurd results,

23 namely the individuals who had withdrawn some money

24 but whose account statements indicated a certain

25 holding, might be recovering more under this

1   valuation method than counterparts who had never

2   withdrawn any money.

3   MR. LAX: I understand that, Your

4   Honor, but --

5   JUDGE RAGGI: For the same

6   investment. And, you know, the law abhors an absurd

7   result.

8   MR. LAX: I understand that, Your

9   Honor, but in this statute there is no absurd result

10   test. What I believe is absurd is that half of the

11   Madoff victims of the worst SIPC liquidation in

12   history didn't receive SIPC protection.

13   JUDGE RAGGI: Well, you know, you

14   suggest that the law does not tolerate any

15   exceptions, and yet our decision in New Times did

16   treat two different forms of investments

17   differently. So that seems to me to run counter to

18   your argument that the law admits no flexibility.

19   The only question is whether these facts warrant one

20   treatment or the other, but I'm not sure your

21   argument that the law does not permit different

22   treatments can be maintained after our New Times

23   decision.

24   MR. LAX: But it can, Your Honor,

25   because these customers, the Madoff customers are in

1   the exact same situation as those New Times

2   customers that received account statements and

3   confirms --

4   JUDGE RAGGI: That suggests that they

5   fall on one side, but it doesn't suggest that there

6   isn't another side to how net equity can be

7   calculated.

8   MR. LAX: Right. But in that very,

9   in that example which was a departure from the

10   statutory framework, the SIPC Trustee could not go

11   out and purchase the New Age Fund securities. There

12   was no legitimate expectation on behalf of the

13   customers that they actually own those securities.

14   No one had any idea what the New Age mutual fund was

15   invested in. And the Trustee couldn't go out and

16   buy those securities.

17   But in this case the SIPC Trustee

18   could go out and buy IBM, Google, Microsoft, all

19   those types of securities.

20   JUDGE RAGGI: What I understand to be

21   at least one of the differences here is that those

22   purchases are not necessarily reflective of what

23   your clients may have invested because their total

24   portfolio is a function of all these fraudulent

25   trades usually done in hindsight that were brought

1   to create that figure. So it's not like purchasing

2   as occurred in New Times, what the client had

3   basically invested.

4   MR. LAX: But that's really a

5   distinction without a difference because when you

6   give a broker-dealer discretion or when you get on

7   the phone with your broker and say, okay, I want to

8   buy that security, there's no difference. The only

9   thing that it establishes more by giving the

10   broker-dealer discretion is you give the

11   broker-dealer a fiduciary responsibility to increase

12   the burden.

13   JUDGE RAGGI: Perhaps I wasn't clear.

14   To use small numbers so as not to get complicated,

15   if one invests $1,000 and the broker, in order to

16   get you to keep that money in the scheme keeps

17   sending you reports that now you have $1500, now you

18   have 2,000, now you have 2500, and here's what it's

19   being invested in, well, you've never put in that

20   extra money and nothing ever, no maturity ever

21   yielded that result, the market could not have

22   yielded it. I don't know how you have a claim that

23   you're entitled to the 2500 afterwards.

24   MR. LAX: Well, if you can go and

25   look and see if your security increased in value,

1 then you would have legitimate expectations in that

2 increase in value. But if you went and checked the

3 market and you looked and your security is not

4 increasing in value, but yet on your account

5 statements it is increasing in value, that might be

6 an exception to the statutory framework, where a

7 legitimate customer's expectations are not met.

8   JUDGE JACOBS: Thank you.

9   MR. LAX: Thank you very much.

10   MS. WAGNER: Good morning, Your

11 Honors. May it please the Court, my name is Karen

12 Wagner and I'm a member of the firm of Davis Polk &

13 Wardwell, representing Sterling Equities and

14 associated entities in this matter.

15   Your Honors, it is our position that

16 the customers' account statement should control in

17 this case. Now obviously there are situations where

18 a customer --

19   JUDGE LEVAL: You're relying on the

20 provision of the SIPA which requires the Trustee to

21 discharge obligations insofar as such obligations

22 are ascertainable from the books and records of the

23 debtor? That's the language that you rely on?

24   MS. WAGNER: Your Honor, I'm relying

25 on the net equity definition, which I think is

1 completely consistent with the language that Your

2 Honor has just recited. The way that we understand

3 the statute to work is this:

4   Outside of SIPA, before SIPA ever

5 comes into place, you engage in a transaction with

6 your broker. Your broker issues you a statement

7 saying you own ten shares of IBM. Under all the law

8 that's applicable prior to the SIPA filing, if you

9 go to your broker and you say I want my ten shares

10 now and the broker says, sorry, I don't have it, you

11 can sue him and you can get a judgment and you will

12 be entitled to your ten shares of IBM.

13   So then the question is, when SIPA

14 comes into play, does something change? Does the

15 broker now have a defense? Especially a defense

16 based on, sorry, I didn't buy your securities and

17 I'm engaging in a fraud, so actually I don't owe

18 this to you anymore? Obviously that doesn't make

19 too much sense.

20   JUDGE LEVAL: So if the broker took

21 your money, if the money comes in and the broker,

22 instead of investing it, pockets a large percent of

23 it and sends you a statement saying that you

24 invested, a fictitious investment, he selects an

25 investment that went plunging down, sorry, I

1   invested for you in this at 100 and it's now worth

2   40, so you're saying that the appropriate debt is

3   the 40 because that's the statement that you

4   received?

5   MS. WAGNER: No, Your Honor. What

6   I'm saying actually is normally your statements

7   control and in this case we believe they control.

8   Now, it certainly is the case in the

9   language Your Honor read, permits the customer, when

10   it's clear that the broker has defrauded the

11   customer and has issued a statement that is

12   inconsistent with what the customer thought he was

13   investing in, the customer can go to the broker and

14   to the SIPC Trustee and say, look, I actually

15   invested $10,000, not $5,000, so my claim is bigger.

16   And section 8B, the provision that Your Honor is

17   reflecting on, permits the customer's claim to be

18   enlarged if the Trustee considers that whatever

19   records the customer has reflect that transfer of

20   funds.

21   JUDGE LEVAL: Let me give you another

22   hypothetical. Supposing that it happens to be a

23   week before the whole thing, the Ponzi scheme is

24   exposed, that a week before, a month before, two

25   people come in on the same day and one of them says,

1 he's an old friend of Mr. Madoff and he says,

2 Bernie, I'm in a terrible situation, I have a

3 desperate need for money for this, that and the

4 other thing, I hope you can do good by my account.

5 And the other one Mr. Madoff decides he doesn't like

6 at all, he's always hated him. And for his friend,

7 they both come in with a million dollars on the same

8 day, and for his friend, he received statements of

9 spectacularly successful trades and the million

10 becomes two million, 2-1/2 million in the space of

11 that week. And the other one, who Mr. Madoff didn't

12 like, his equity that he engaged in, distinctly

13 unspectacular trades, and his investment drops and

14 it's practically all lost.

15   So you're saying to me that when the

16 whole thing comes apart a week later, the proper way

17 to measure what is owed to the two of them is that

18 the one who received notice of entirely fictitious,

19 spectacularly successful trades is 2-1/2 million

20 where the other only gets $50,000?

21   MS. WAGNER: Your Honor, two

22 responses to that. First of all, that is not the

23 situation that is presented to you today. Today the

24 record is clear that --

25   JUDGE LEVAL: The situation that's

1   presented to us today is whether peoples' accounts

2   should be valued on the basis of fictitious trades

3   that never occurred, on the basis of statements that

4   were simply figments of the imagination and never

5   involved any real securities whatsoever.

6   MS. WAGNER: Your Honor, the

7   securities on people's statements, and this is what

8   is in the record before you today, they were

9   securities that do exist in the market.

10   JUDGE LEVAL: Oh, I know the

11 securities exist, but the ownership of those

12 securities by those persons was entirely fictitious.

13   MS. WAGNER: Absolutely correct.

14 Absolutely correct. They were not owned by Mr.

15 Madoff --

16   JUDGE LEVAL: As in my example that I

17 gave you.

18   MS. WAGNER: Yes. Mr. Madoff

19 breached his obligations to his customers to buy any

20 securities. But the customers received statements

21 that show ownership of these securities --

22   JUDGE LEVAL: As in my example.

23   MS. WAGNER: And under all

24 nonbankruptcy law those statements give them

25 ownership rights and I think SIPA also gives them

1 ownership rights.

2   Now, your question I think goes to

3 the question of whether somebody is a customer. If

4 somebody knowingly invests in -- gives money to

5 Mr. Madoff, knowing that Mr. Madoff is engaged in a

6 Ponzi scheme --

7   JUDGE LEVAL: No, I didn't say they

8 knowingly knew.

9   MS. WAGNER: Well, I'm getting there.

10 If you know it, if they know it, then I think they

11 may not be a customer and then maybe none of this

12 protection works for them. But if they don't know

13 it and if they get a statement that appears

14 consistent with the market, which is what happened

15 here, I would suggest to you all the law says they

16 are entitled to rely on that statement.

17   JUDGE LEVAL: That was my

18 hypothetical to you. These people gave money to

19 Madoff in good faith and they received statements

20 which they believed to be accurate. One of them was

21 disappointed and one of them was very, very happy.

22   MS. WAGNER: I think the statement

23 controls, Your Honor, when the customer believes

24 rationally that the statements that they're getting

25 are consistent with what they own. And the reason,

1 Your Honor, is because you never know when your

2 broker is engaged in a Ponzi scheme or some other

3 nontrading of securities. You don't have any

4 physical securities anymore in your possession. You

5 have no idea what's going on behind the scenes. You

6 must rely on your statement.

7   JUDGE JACOBS: What I hear you

8 arguing is that the fund should pay out in respect

9 of each investor whatever amount Madoff made up

10 chewing on his pencil and looking at the ceiling.

11   MS. WAGNER: Your Honor, customers

12 are entitled to rely on their statements and I

13 believe the fund is obliged to honor their

14 expectations, unless it can be shown that they are

15 not customers because they actually knew something

16 was going on. I do believe that. I also believe

17 that it's consistent with the New Times decision.

18   JUDGE JACOBS: Well, your reference

19 to expectations, which of course are legitimate

20 expectations, is a reference to wording in New Times

21 that deals with whether the account will be

22 classified as one for cash or as an investment in

23 securities. Every one of the claimants here has

24 already gotten the benefit of that classification.

25 That means that they have, as it were coverage, up

1   to half a million instead of 100,000. But I'm not

2   sure legitimate expectations governs what the

3   precise amount of money that they get, within that

4   limit.

5   MS. WAGNER: Your Honor, I'm not sure

6   it's legitimate expectations exactly, either. I'm

7   saying that outside of SIPA the statement controls

8   unless you can conclude that there is some reason

9   why it would not. And I'm saying inside of SIPA the

10 statement also controls subject to, you know, if the

11 broker doesn't --

12   JUDGE JACOBS: What I don't

13 understand is you're saying controls unless there's

14 some reason why not. And the question is --

15   MS. WAGNER: The reason why not is

16 the customer is complicit. Otherwise it controls.

17 That is our position.

18   JUDGE JACOBS: So you're saying

19 that's the only reason?

20   MS. WAGNER: Yes, I am, Your Honor.

21 The customers are entitled to this protection, and

22 the reason is they have no other way -- the whole

23 system is dependent upon the customers' statements,

24 the statements issued by the broker saying this is

25 what you own.

1   JUDGE LEVAL: In New Times was there

2   a challenge in this Court to the valuation by the

3   customers who had fictitious nonexisting securities

4   on their statements? I'm sorry. With respect to

5   the customers who had actual securities, true

6   securities?

7   MS. WAGNER: Your Honor, there was no

8   challenge.

9   JUDGE LEVAL: There was no challenge

10   to that.

11   MS. WAGNER: That's correct. The

12   only issue before your Court in that case was when

13   you cannot value the securities because they never

14   existed, that's when you come into a situation where

15   SIPC is exposed to an unreasonable result because

16   there is no way of knowing --

17   JUDGE LEVAL: So our Court decision

18   in that case does not represent a precedent for

19   using the account statement on the other securities

20   if it wasn't challenged, it wasn't the subject of

21   dispute.

22   MS. WAGNER: I think that's correct,

23   Your Honor, but I think the analysis in that

24   decision, which is that if the statute can be

25   followed, it must be followed, but if it cannot be

1   followed, then some other approach is needed, is

2   directly applicable to this case because in this

3   case the statute can be followed.

4   JUDGE JACOBS: In that case the

5   requisite analysis was frustrated. It was

6   impossible to figure out what the real value is of

7   securities issues that never existed of companies

8   that were just figments of the imagination and

9   therefore people were limited to what they had paid

10 in, less what they took out. Why is this not an

11 analogous situation in the sense that the securities

12 may have real names, but the transactions that

13 generated the upside were just as fictitious as the

14 stock issues in New Times?

15   MS. WAGNER: Your Honor, the whole

16 system is set up to protect the customer, so I think

17 you need to look at it from the customer's

18 perspective and from the customer's perspective the

19 transaction is not fictitious. The customer

20 provided funds to a broker and said, please invest

21 this, it's your discretion, you invest it. The

22 broker kept issuing statements that looked like they

23 were consistent with the market, that told the

24 customer this is what you own. This went on for 30

25 years, it seemed to work pretty well for a pretty

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 1   long time.
 2                   The customer had every reason to
 3   assume that the protections of the securities laws
 4   of Article 8 and finally of SIPA would govern in
 5   this case.
 6                   JUDGE JACOBS:  Well, then it does
 7   seem awfully unfair to the people who were credited
 8   with having fake securities in New Times that they
 9   shouldn't get the benefit of exactly the same
10   expectations.  After all, ordinary investors don't
11   really have the ability to go out and find out
12   whether, you know, Blue Sky Corporation actually
13   exists or has a certain capitalization or is traded
14   here or there.
15                   It just seems, under your argument,
16   it seems to prove too much because then New Times is
17   wrong.  All of those people were unfairly treated,
18   according to you.  And they may indeed have been
19   unfairly treated in the overall scheme of things.
20   The question is were they unfairly treated under the
21   statute?
22                   MS. WAGNER:  Your Honor, I think
23   those customers were entitled to what was on their
24   statements and I think that's what the statute would
25   control.  The problem is no one could give them what
```

1   was on their statements, it didn't exist. So in

2   that circumstance something --

3   JUDGE RAGGI: Well, no one is going

4   to give your clients 20 shares of AT&T. All of this

5   is money. So the question is why does this money,

6   which reflects thousands, if not millions of

7   transactions that are entirely fictitious, yield a

8   dollar figure that is more worthy of SIPA protection

9   than the dollar figure that was reached by purported

10 purchases of nonexisting companies in New Times.

11   MS. WAGNER: Your Honor, I think the

12 issue is simply that the fictitious securities in

13 New Times could not be valued. They certainly

14 couldn't be bought but they also for the same reason

15 could not be valued and, therefore, SIPC would be

16 exposed to risk which there was no way to tether in

17 any way to the market.

18   Here, what is before you today, the

19 statements customers received all reflect real

20 securities that were traded, according to the

21 statements, at prices you would expect in the

22 market. Here you can determine --

23   JUDGE RAGGI: But that assumes that

24 the customer took risks in the market. And these

25 customers, as I understand it, were never at risk

1   because they were never in the market, but more to

2   the point, even their statements were concocted

3   after the fact, always to show gains. So there was

4   never the risk. And that suggests to me that the

5   distinction you're drawing isn't one that's

6   particularly persuasive. What have I missed,

7   perhaps?

8   MS. WAGNER: Your Honor, I think the

9   point again is this has to be regarded from the

10   perspective of the customer. The customer has no

11   information about what the broker is doing except

12   what the broker tells the customer. The customer is

13   relying on that information and month after month

14   after month when the customers received the

15   statements, they relied on that information and they

16   acted as if --

17   JUDGE RAGGI: That's the same in both

18   the circumstance of the fraudulent stock and the

19   fraudulent transactions. I need to know how we

20   distinguish those.

21   MS. WAGNER: The distinction is

22   simply can the statute be applied or can it not. If

23   it can be applied because, I agree that SIPC is not

24   going to go out and buy the AT&T, but SIPC can tell

25   you how much the AT&T was worth on the filing date.

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 1    You could not tell in the New Times case how much
 2    the securities were worth because they never
 3    existed, they were never traded, as the decision
 4    says, there were no prospectuses, there were no
 5    financials, you had no idea what the securities were
 6    worth, so there was just no way to do what the
 7    statute told you to do.
 8                    JUDGE LEVAL:  Can you clarify for me
 9    something, which is to what extent are we talking
10    about an issue of dividing up a pie of predetermined
11    size?  In other words, how large is each of the
12    former customers' size of participation, slice of a
13    pie of a predetermined set of assets, what remained
14    after the debacle.  And to what extent are we
15    talking about a distinction that would change the
16    size of the overall pie as a result of bringing in
17    new funds from SIPC?
18                    MS. WAGNER:  Your Honor, there are,
19    as you note, conceptually at least, two pies.  One
20    is the SIPC advance, which is there for every
21    customer, whether or not another customer gets it,
22    every customer is entitled to it.  So in that sense,
23    whatever the customer's claim is, it's not going to
24    reduce the next customer's claim.
25                    Ultimately there will also be, of
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1 course, an estate, the Madoff estate once the

2 Trustee has done all his litigation, and in that

3 case the relative recovery on claims will be

4 affected by how many claims there are. But not in

5 the first instance.

6   JUDGE LEVAL: And so you're saying

7 that there are two different pies, one of which is

8 of a predetermined size, and that's the estate, and

9 the other is the pie that is created by the SIPC

10 contributions, and that's, the size of that pie will

11 vary according to how this question is determined?

12   MS. WAGNER: That's correct, Your

13 Honor. One customer's recovery from the fund will

14 not affect another customer's recovery from the

15 fund.

16   JUDGE LEVAL: And how do the size of

17 those two pies compare to one another? Which is the

18 bigger pie and by how much?

19   MS. WAGNER: I can't answer that

20 question, Your Honor. The SIPC fund, to the best of

21 my knowledge, although you can certainly ask SIPC,

22 is enough to cover everybody who's involved here

23 today. The Madoff estate --

24   JUDGE LEVAL: Enough to cover them?

25 You mean to make them whole?

1   MS. WAGNER: No. Enough to give

2   them -- the only thing SIPC is liable for is

3   $500,000 per claim. So there is enough for that.

4   The Madoff estate I don't think we

5   know yet what exactly the size of that estate is.

6   The Trustee is still engaged in litigation. I think

7   right now it's seven or eight billion or something

8   like that.

9   JUDGE LEVAL: It seems to me that the

10 argument that you're making makes better sense in

11 the SIPC application than it does in the division of

12 the pie. As to the division of the estate pie, who

13 gets more and who gets less would be entirely a

14 function of, as Judge Jacobs was saying,

15 Mr. Madoff's imagination.

16   MS. WAGNER: Your Honor, the question

17 of who gets more and who gets less, and that is I

18 think the motivating factor here in what the Trustee

19 is doing, you have to go and figure out, well, what

20 body of law is going to govern that question. Who

21 decides -- where is it coming from that who gets

22 more and who gets less is the controlling issue in

23 this case. And I would suggest to you that is not

24 something that appears in SIPA, except to the extent

25 that SIPA does give the Trustee the authority to

1   avoid preferences. Preference is the concept that

2   you use when you want to equalize recoveries across

3   all creditors. And that is a fine and important

4   bankruptcy principle, but it's a 90-day principle.

5   It is not one that goes across 35 years. It's a

6   90-day principle. And that I think is completely

7   consistent with the net equity recovery.

8   JUDGE LEVAL: So looking at the part

9   that comes from SIPA, are any of the Madoff

10 customers harmed by the application of the last

11 statement approach?

12   MS. WAGNER: Yes, they are, Your

13 Honor.

14   JUDGE LEVAL: They definitely are

15 harmed in the division of the estate pie, the ones

16 who are more recent investors are harmed because a

17 larger percentage goes to the earlier investors

18 whose accounts built up and built up over the years.

19 But how are customers harmed with respect to the

20 part that comes from SIPA?

21   MS. WAGNER: Your Honor, they are

22 harmed because the result of the, what is called the

23 cash-in/cash-out approach here, is that customers

24 who would otherwise get more from SIPA are going to

25 get less because this will reduce their claims.

1 Because the effect of what the Trustee is doing, he

2 takes the last statement and then he says all your

3 prior statements were invalid, just like this one,

4 so we're going to deduct from what the broker should

5 owe you, we're going to deduct those valid payments

6 that you got in the past and, therefore, your claim

7 is going to be lower.

8   So, for example, if you had a claim

9 for -- if your customer statement says you are owed

10 a million dollars and the Trustee goes through his

11 analysis and finds out that you're owed $200,000,

12 then the SIPC recovery is $200,000 rather than

13 $500,000. And that is how people are being harmed

14 by this, even as to the SIPC fund.

15   JUDGE RAGGI: May I be certain I

16 understand why you think that the Trustee did not

17 have the discretion to proceed as he did under

18 78fff-2B. That's the section that says that he's

19 obliged to discharge net equity claims only insofar

20 as such obligations are ascertainable from the books

21 and records of the debtor or are otherwise

22 established to the satisfaction of the Trustee. I

23 just want to be sure I understand your position.

24   MS. WAGNER: Surely, Your Honor.

25   The statutory context is that you

 1 have a net equity claim and once the Trustee

 2 understands what that is, then he has to discharge

 3 it, 8B, your statutory framework here, you have to

 4 then discharge it.

 5   The customer statement is a record

 6 which brokers are required to maintain and to give

 7 their customers.

 8   JUDGE RAGGI: But that's not talked

 9 about in the statute as the document that the

10 Trustee has to rely on.

11   MS. WAGNER: None of them is talked

12 about specifically.

13   JUDGE RAGGI: So, what it says is

14 he's obliged to discharge them insofar as such

15 obligations are ascertainable from the books and

16 records of the debtor or are otherwise established

17 to the satisfaction of the Trustee. That's the

18 statutory language. Do you agree that that controls

19 his determination here, that that is the relevant

20 section, or not?

21   MS. WAGNER: No, I do not agree, but

22 I don't think it's inconsistent with what I think is

23 the governing provision. The governing provision is

24 the net equity definition. And I believe the net

25 equity definition says that you must give the

 1 customer what the broker owes the customer on the

 2 date of filing. I think you determine that by

 3 looking at the statements, generally speaking.

 4 There may be times when you have to see if there's

 5 been some intervening event, but generally speaking

 6 you look at the statement.

 7   Once you look at the statement, then

 8 8B says to the Trustee, now you've got to go and

 9 deliver securities or cash consistent with that. If

10 the customer, for example, doesn't have a statement

11 because the customer just isn't too good at keeping

12 records, the customer can go to the Trustee and say,

13 you know, he owed me ten shares of AT&T and the

14 Trustee says, prove it, and if there is some way to

15 prove it the Trustee is enabled by that provision to

16 take other information in order to prove the

17 Trustee's claim. But I don't think that provision

18 governs in the first instance and there is certainly

19 nothing in that provision that says do not look at

20 the statements. The statements on their face would

21 have to be --

22   JUDGE RAGGI: But it says you pay

23 obligations only insofar as they are ascertainable

24 from the books and records of the debtor. My

25 understanding was that the Trustee's position is

1   that when you look at the books and records of the

2   debtor, the purchases on particular days that were

3   ascribed to particular accounts never occurred.

4   And, indeed, were not identified for anyone until

5   after the fact, when it was clear that they had been

6   profitable.

7   And given that that was the scheme,

8   the Trustee concluded that you couldn't ascertain

9   that these profitable transactions had taken place

10   from the books and records and, therefore, that that

11   would not be a reliable way to calculate the net

12   equity that was appropriately discharged. And I

13   just need to understand why you don't think that

14   that is a decision that that statutory section

15   affords the Trustee the discretion to make.

16   MS. WAGNER: Your Honor, again, to go

17   back to my first principle here, this should protect

18   customers. That's the name of the statute and the

19   customer should be the focus.

20   JUDGE RAGGI: I understand that we're

21   all interested in statutory purpose, but we are

22   limited by statutory language.

23   MS. WAGNER: Absolutely, absolutely.

24   JUDGE RAGGI: So I'm asking you again

25   why that statutory language did not afford the

 1 Trustee the discretion he exercised here.

 2   MS. WAGNER: Because he's not

 3 permitted under that section to ignore the

 4 statements. The statements are mandatory records of

 5 the broker and if you look at it from the customer's

 6 perspective and if you analyze it from the day

 7 before the filing, before SIPA comes into place

 8 under Article 8 of the UCC and under the federal

 9 securities laws, the customer can sue the broker on

10 the day before the filing based on the statement.

11   JUDGE RAGGI: I'm sure I'm not making

12 myself clear, but the totality of the books and

13 records show why those statements are totally

14 fraudulent. Namely, there is no book or record that

15 even shows a false transaction on the day it's

16 supposed to have happened. Rather, the transaction

17 is identified sometime down the road when it's clear

18 it was profitable.

19   So, to that extent, the Trustee

20 didn't think there ever was a transaction. It's not

21 like Mr. Madoff's told someone today that he

22 purchased AT&T for him. Rather he tells him next

23 week that today he purchased AT&T for him, when he

24 can assure him that it was a profitable transaction,

25 and that the Trustee was not prepared to accept as a

1   way of calculating dischargeable net equity. What

2   am I missing here in your argument?

3   MS. WAGNER: Your Honor, under

4   nonSIPA law the customer's rights derive from the

5   statement. It does not matter whether the broker

6   buys or doesn't buy the security. Under the law the

7   right of the customer derives --

8   JUDGE RAGGI: Under all kinds of

9   other laws that would be where liability would

10 attach, I understand that.

11   MS. WAGNER: Fine. So then you go to

12 SIPA, which is supposed to protect the customer.

13   JUDGE RAGGI: Yes.

14   MS. WAGNER: Now, does that change

15 everything? I would argue it doesn't change

16 anything. I would argue that the customer is still

17 entitled to rely on his statement, does not matter

18 whether the broker did or didn't buy the security,

19 the net equity definition is definitely conditional,

20 what would have been the value if the securities

21 positions had been liquidated, and the SIPC fund is

22 there precisely for a situation in which the broker

23 did not buy the securities he was supposed to buy.

24   So I would argue, Your Honor, that

25 the two situations, the Securities Investor

1 Protection Act continues the protection that was

2 available to the customer prior to the filing. In

3 which manner it is entirely consistent with other

4 forms of insolvency law where the customer's claim

5 remains the same inside or outside of bankruptcy.

6 The recovery of course is different, but there is no

7 reason why the Securities Investor Protection Act

8 would suddenly reduce the customer's claim against

9 the broker, just because the broker breached his

10 obligation to the customer. That doesn't make

11 sense. It makes sense that the Securities Investor

12 Protection Act should be read consistently with the

13 whole framework of the securities laws.

14   That would be my argument.

15   JUDGE JACOBS: Let me make one

16 clarification. All of the claimants in this suit

17 are split strike customers? None of them are in the

18 nonsplit strike customer category?

19   MS. WAGNER: Your Honor, that is

20 my -- yes. That's the case.

21   JUDGE JACOBS: Thank you very much.

22   MS. WAGNER: Thank you, Your Honors.

23   JUDGE JACOBS: There will be

24 rebuttal.

25   MS. WAGNER: Yes, thank you.

1   JUDGE JACOBS: In the meantime, we'll

2   hear from the others.

3   MS. WANG: May it please the Court,

4   my name is Josephine Wang, I represent the

5   Securities Investor Protection Corporation or SIPC,

6   S-I-P-C.

7   The Court in these appeals is being

8   asked to decide what customers are owed in the

9   Madoff liquidation proceeding. The appellants

10   contend that the Court must be guided by the last

11   account statements that were issued to them by the

12   broker-dealer. However, those statements are

13   fictitious. They reflect trades --

14   JUDGE RAGGI: But if they were to sue

15   Mr. Madoff, that wouldn't be a defense for him. He

16   would be obligated to pay them what the statements

17   he sent them, wouldn't he?

18   MS. WANG: That's absolutely correct.

19   JUDGE RAGGI: All right. So why

20   should --

21   MS. WANG: That's absolutely correct,

22   if the firm had remained in business, Your Honor.

23   I beg your pardon?

24   JUDGE RAGGI: Why should SIPC's

25   calculation be different?

1   MS. WANG: Because we're bound by a

2   federal statute and that statute does not authorize

3   a trustee to benefit certain customers at the

4   expense of other customers; because the prices on

5   the statements were back-dated; because the profits

6   or so-called profits were fictitious.

7   JUDGE LEVAL: How is it at the

8   expense of other customers when you're talking about

9   the SIPC, the funds coming from SIPC that measure

10   for each customer independently how much that

11   customer is entitled to?

12   MS. WANG: Well, first of all, we're

13   not only talking about the funds that come from

14   SIPC. We're talking about customers who are all

15   eligible to share pro rata in a fund of customer

16   property.

17   What you have here are at least two

18   types of customers. You have customers who, while

19   the firm was in business, withdrew their principal,

20   perhaps completely innocently, and also received

21   what they believed to be profits. However, those

22   profits consisted of other investors' monies because

23   no trades were actually made. This was a Ponzi

24   scheme.

25   And then you have a second group of

1   investors and those are people who never -- who did

2   not withdraw their principal, whose money is missing

3   because it was used to pay the earlier investors.

4   JUDGE RAGGI: So where is this

5   customer property coming from that you say that in

6   addition to the SIPA maximum of $500,000, where is

7   the customer property coming from?

8   MS. WANG: Customer property is a

9   term that's defined under the statute and it's all

10   property that was held by the broker-dealer for

11   customers. It's property that belonged to customers

12   that the Trustee finds when it takes possession of a

13   broker-dealer, but it's also customer property that

14   the Trustee recovers during the liquidation perhaps

15   by bringing third-party actions.

16   JUDGE RAGGI: So is this any money in

17   Mr. Madoff's possession and then clawback?

18   MS. WANG: It could be. It could be.

19   But returning to Your Honor's

20   question, all customer property is shared pro rata

21   among customers. So if you rely on the last account

22   statement, that means that people who are owed

23   simply fake profit will be sharing with other

24   customers who are actually owed their principal.

25   And, once again, those profits will be paid out of

 1   other customers' money, and that is simply unfair.

 2   JUDGE LEVAL: That part is very

 3   clear. But it's the part that relates to the money

 4   coming from SIPC.

 5   MS. WANG: It also implicates the

 6   SIPC fund because obviously the exposure will be

 7   much, much greater. We believe there to be an

 8   actual exposure of approximately 17 to 20 billion.

 9   If you rely on the last account statement, obviously

10   the exposure becomes much greater, roughly 64

11   billion or thereabouts.

12   So you now have people who are owed

13   fake profit who will be eligible for SIPC

14   protection, which means that SIPC would of course

15   have to advance that much more.

16   JUDGE JACOBS: I'm a little confused.

17   I had thought that your argument would be that if

18   SIPC paid out $500,000 to any given investor, SIPC

19   would then be subrogated to a 500,000-dollar claim

20   against the estate.

21   MS. WANG: That's absolutely correct.

22   Against the fund of customer property. To the

23   extent that any single customer has been fully

24   satisfied out of a SIPC advance, SIPC steps into the

25   shoes of that customer and takes his share or his or

1 her share of customer property. So that there is no

2 double recovery by that customer.

3   JUDGE JACOBS: And that does seem to

4 me to suggest that a 500 maximum payment by SIPC

5 could have some impact on other investors in the

6 bankruptcy proceeding simply because of the claims

7 that SIPC would have by virtue of having paid that

8 claimant in the SIPC process.

9   MS. WANG: I'm not sure that I'm

10 following Your Honor.

11   JUDGE JACOBS: If SIPC is subrogated

12 to the claim, then having paid out the $500,000,

13 SIPC has a 500,000-dollar claim against the --

14   MS. WANG: Fund of customer property,

15 yes, standing issues of the customer.

16   Theoretically what should happen or

17 what happens is that the Trustee accumulates the

18 fund of customer property, that fund is distributed

19 pro rata among customers and then to the extent that

20 there is any shortfall, the SIPC protection is

21 available.

22   JUDGE JACOBS: Let me see if I

23 understand -- I'm sorry.

24   JUDGE RAGGI: I was going to say, but

25 it all relates to how the customer property is

1   divided up. If the only way anyone were to be

2   compensated was through SIPC, one customer's receipt

3   of $500,000 does not affect whether another customer

4   will receive an amount up to $500,000. That's what

5   the law provides, right, each of them can receive

6   that, depending on how net equity is calculated.

7   MS. WANG: Well, yes, that's true,

8   Your Honor --

9   JUDGE RAGGI: And dollars given to

10   one person will not take it away from another.

11   MS. WANG: That's true, Your Honor,

12   but that's not how the statute works because it does

13   affect or implicate the fund of customer property

14   because --

15   JUDGE RAGGI: Right.

16   MS. WANG: -- as your Honor pointed

17   out, there is a SPIC subrogation right.

18   JUDGE LEVAL: So if I understand

19   correctly then, when -- if SIPC is subrogated to the

20   customers' position with respect to claims against

21   the estate --

22   MS. WANG: Against the fund of

23   customer property, yes.

24   JUDGE LEVAL: Then to the extent that

25   SIPC pays one customer based on that customer's

1   inflated long-term position that grew much, much

2   larger than the customer's initial investment,

3   notwithstanding withdrawals, SIPC's payment of the

4   full $500,000 to that customer will reduce another

5   customer's entitlement because SIPC then becomes a

6   claimant against the estate.

7   MS. WANG: That's correct, Your

8   Honor.

9   JUDGE JACOBS: Now, if SIPC becomes a

10   claimant against the estate, asserting a

11   500,000-dollar claim, that doesn't mean that SIPC

12   will recover $500,000 even if there is sufficient

13   funds. It may well be that SIPC will have paid out

14   more money under the governing statute than gives it

15   the ability to recover that whole amount in the

16   bankruptcy.

17   MS. WANG: Well, again, SIPC stands

18   in the shoes of the customer, so SIPC won't receive

19   anything more or anything less than the customer

20   would be entitled to.

21   JUDGE JACOBS: Let me give you this

22   hypothetical, because I just would like to

23   understand what your position is.

24   Assume that a customer gives the

25   broker, a faithless broker $100 to buy 100 shares of

1 a blue chip stock, blue chip corporation. The

2 broker takes $80 and blows it on cigars. The stock

3 doubles in value, on the market. The company, the

4 brokerage then goes bust. It seems to me there are

5 three possible options. Either, according to SIPC,

6 the customer gets the $20, which is the value of 20

7 shares on the account statement, or the customer

8 gets $100, which was what was invested, or the

9 customer gets $200, which is the value of what

10 should have been on the account statement.

11   What's SIPC's position?

12   MS. WANG: Well, there are a number

13 of variables. We're assuming that the customer has

14 received an account statement? Are we assuming that

15 the account statement reflected in all respects

16 market reality?

17   JUDGE JACOBS: No, it doesn't reflect

18 market reality.

19   MS. WANG: It does not.

20   JUDGE JACOBS: We're assuming the

21 customer paid $100 for 100 shares, $80 was taken by

22 the broker and wasted, and the broker just reflected

23 a transaction for the purchase of 20 shares worth

24 $20.

25   MS. WANG: If the account statement

1   does not reflect market reality so that we're

2   dealing with artificial numbers, then what the

3   customer is entitled to is the $100 back.

4   JUDGE JACOBS: But the market reality

5   is that the stock doubled.

6   MS. WANG: Then is Your Honor saying

7   that even though the trade was not actually placed,

8   what was reflected --

9   JUDGE JACOBS: I'm asking you what

10 would SIPC pay. I'm not saying anything. I'm not

11 planning to pay anything.

12   MS. WANG: I'm trying to understand

13 what the hypothetical is, Your Honor.

14   JUDGE JACOBS: The hypothetical is

15 $100 is invested to buy 100 shares, the broker is

16 faithless, eats up $80 worth, buys only $20. 20

17 shares appears on the account statement, the company

18 goes bust and the stock has doubled in value on the

19 market.

20   MS. WANG: Right. So, if the

21 statement reflects market reality in the sense

22 that -- whether or not the securities have actually

23 been bought, then what the customer is owed is in

24 fact what his account statement shows and he is in

25 the same situation as that first group of claimants

1 in the New Times case.

2   JUDGE RAGGI: $40, so the 20-dollar

3 investment doubled and is worth $40. Even though he

4 gave the fellow 100, you're saying that's all he's

5 entitled to?

6   MS. WANG: No. I'm saying that he is

7 entitled to the shares at whatever the stock is

8 trading on that particular date.

9   JUDGE RAGGI: Even though they were

10 not reported on his statement?

11   MS. WANG: I may have misunderstood

12 Your Honor's question. But as I understood it, the

13 customer has received an account statement which

14 reflects the purchase of 100 shares of stock, and

15 that trade --

16   JUDGE JACOBS: No. It reflects the

17 purchase of 20 shares of stock.

18   MS. WANG: 20 shares of stock.

19   JUDGE JACOBS: Right. At a dollar

20 each. But the customer gave $100 to purchase 100

21 shares.

22   MS. WANG: I see. I'm sorry, I

23 misunderstood your question.

24   JUDGE JACOBS: By the time everything

25 went bust, the company doubled in value. So what

1   does SIPC pay or what does SIPC argue that it should

2   pay?

3   MS. WANG: A customer is protected --

4   a customer by definition is protected against the

5   loss of cash for securities that have been converted

6   by the broker. That's in the definition of

7   customer.

8   JUDGE JACOBS: So the customer gets

9   $200?

10   MS. WANG: The customer gets whatever

11 his account statement shows that reflects market

12 reality. But to the extent that the entire sum was

13 not invested and doesn't appear on that statement,

14 then he gets the balance in cash.

15   JUDGE JACOBS: Okay. I think I

16 understand your position.

17   MS. WANG: I hope I understood Your

18 Honor's question. I apologize if I confused you.

19   JUDGE JACOBS: No, I understand.

20   JUDGE RAGGI: To the extent we have a

21 fraud here in which individuals invested money and

22 were repeatedly told through their account

23 statements that they were now, they now had holdings

24 of several multiples of their original investments,

25 and to the extent you also agree that the

1   perpetrator of the fraud would be liable to them for

2   the account statement amount, I'm not sure why you

3   want a different calculation for SIPA. After all,

4   you're not going to have to pay anyone full dollar,

5   it's going to be $500,000 plus whatever customer

6   monies were recounted. Why should there be

7   differing ways of assessing the customer's net

8   equity, depending on who's being sued or who's going

9   to be giving the money?

10   MS. WANG: It depends on the facts of

11   the case, Your Honor. And our obligation is to make

12   sure that the statute is correctly enforced. We are

13   not just looking at SIPC's liability here. That's

14   probably the last of our concerns.

15   JUDGE RAGGI: Have you taken the view

16   that it would have been error for the Trustee to

17   have treated net equity by reference to the account

18   statements, that he would have been precluded by the

19   statute from doing so?

20   MS. WANG: Yes, Your Honor.

21   JUDGE RAGGI: And where in the

22   statute is the language that would have precluded

23   him from looking to the account statement for the

24   net equity?

25   MS. WANG: It's the language that was

1   discussed earlier, section 78fff-2B, where the

2   Trustee can only honor obligations to the extent

3   that they're supported by the books and records or

4   otherwise established to the satisfaction of the

5   Trustee.

6   JUDGE RAGGI: Well, how do the books

7   and records of the debtor ever establish

8   transactions that never take place? And I'm

9   thinking of something very basic so that we avoid

10   any kind of complicated hypothetical.

11   The customer calls the dealer and

12   says, buy 100 shares of AT&T today and the broker

13   says, fine, and never does it. I mean, that doesn't

14   appear on his books and records, and yet I don't

15   think you would argue that the customer wouldn't

16   have a claim for that, especially if it appears on

17   his account statement, that 100 shares were bought.

18   MS. WANG: Well, I'd like to answer

19   Your Honor's question in the context of this case.

20   JUDGE RAGGI: Please.

21   MS. WANG: Because the books and

22   records in fact show that no trades had occurred and

23   undoubtedly --

24   JUDGE RAGGI: As in my hypothetical,

25   no trades occurred.

1   MS. WANG: Yes. But they showed

2   it because the volume --

3   JUDGE RAGGI: As in New Times no

4   trades had occurred in the established stocks.

5   MS. WANG: Right. But I think, as I

6   understood Your Honor's question, the question is

7   how can the books and records show a nonevent?

8   Well, for example, the books and records showed

9   confirmation of a certain number of trades and yet

10   the volume of trades being put on on that particular

11   day, or actually the amount of fictitious trades

12   that were being confirmed far exceeded the volume of

13   actual trades.

14   JUDGE RAGGI: You mean that the

15   market.

16   MS. WANG: Correct.

17   Prices. The prices that were

18   confirmed were outside of the range of real prices

19   on that particular day.

20   JUDGE LEVAL: What you're saying is

21   that the books and records, as understood in the

22   statute, means the truth that can be determined from

23   the books and records as opposed to the ostensible

24   false statement made?

25   MS. WANG: It means more than just

1   one component of the books and records. Certainly

2   the account statements are part of the books and

3   records. But under the federal securities laws a

4   broker-dealer has to maintain many types of books

5   and records. I think under rule 17A there are

6   probably more than 20 categories of them. And yet

7   the books and records aren't always necessarily

8   dispositive by themselves, because they may be

9   missing, they may be incomplete, they may have false

10   information, and Congress recognized that and so it

11   said that alternatively the claims have to be

12   established to the satisfaction of the Trustee.

13   I see that my time is up. Thank you,

14   Your Honors.

15   JUDGE LEVAL: It says insofar as

16   ascertainable from the books and records.

17   MS. WANG: Correct, Your Honor.

18   JUDGE LEVAL: And that supports the

19   implication that you're arguing, that one just

20   doesn't take what is stated on the ostensible books

21   and records and treat it as fact. You have to see

22   what can be ascertained from a study of the entirety

23   of the books and records.

24   MS. WANG: Absolutely, Your Honor.

25   JUDGE LEVAL: Which in this case

1   demonstrates a Ponzi scheme which nobody ever had

2   any investment made.

3   MS. WANG: That's absolutely correct,

4   Your Honor. Thank you.

5   MR. SHEEHAN: Good morning, Your

6   Honors. David Sheehan, Baker Hostetler, attorney

7   for the Trustee.

8   I would submit that the Trustee in

9   this case has not only followed reasonably the

10 statutory construction, by doing what he did, but he

11 did so in a reasonable exercise of his discretion.

12   This is a Ponzi scheme. It's a zero-

13 sum game. The customer fund is the money that went

14 in. We can't talk about anything else. Can't talk

15 about profits. Can't talk about stocks.

16   JUDGE JACOBS: The SIPC fund is not

17 the customer fund.

18   MR. SHEEHAN: No. I said the

19 customer fund -- if I said SIPC fund I misspoke.

20   JUDGE JACOBS: No, no. But the SIPC

21 fund is what we're talking about here today.

22   MR. SHEEHAN: There is no SIPC fund

23 without a net equity claim, Your Honor.

24   JUDGE JACOBS: Well, that may be.

25   MR. SHEEHAN: The way the statute

1 reads is this: You get an advance from SIPC if you

2 have a positive net equity claim. In a zero-sum

3 game the only person that could possibly have that,

4 only person, is the person who didn't get his money

5 out. There can't be anybody else who has a claim

6 for a SIPC advance. It's an advance. It's an

7 advance against the money owed to you by the broker.

8 If the broker doesn't owe you any money, he gave it

9 all back and then some, there is no SIPC advance.

10 There is no $500,000.

11   JUDGE RAGGI: Well, you don't think

12 the broker who told people over the course of 30

13 years that they had a statement that increased at

14 the rate of 15 percent a year or whatever owes them

15 only what they put in at the start of the 30-year

16 investment? You think that's all the broker owes

17 these people?

18   MR. SHEEHAN: In a Ponzi scheme, yes.

19 Absolutely. Why would he owe them anything more?

20 The statute --

21   JUDGE RAGGI: But fraud.

22   MR. SHEEHAN: Fraud is a general

23 creditor claim. That's what's getting confused

24 here. We're talking about two funds. The customer

25 fund of property is the cash and securities

1 deposited with the broker. The broker has an

2 obligation to pay that --

3   JUDGE RAGGI: Even the government of

4 the United States, the SEC thinks it's the current

5 value of the money, not just what they put in 30

6 years ago.

7   MR. SHEEHAN: I don't know if I agree

8 with that. I think it's only what they put in. If

9 in fact it was never invested, if in fact there's no

10 profits, no transaction, how did the fund grow?

11 Where does it come from?

12   JUDGE RAGGI: That's the injury from

13 the fraud, is that if the individuals had known it

14 wasn't going to be invested, they would have put it

15 somewhere else and hoped to profit from it.

16   MR. SHEEHAN: Absolutely. And when

17 they have a general creditor claim, then they get

18 that access to those funds. Let me explain just

19 what I mean by that.

20   What we're trying to do here, what

21 we're trying to do is to recover the monies that

22 belong in the fund. Because it's a Ponzi scheme,

23 there's only one thing those can be. That's other

24 people's money.

25   By way of example, when we recently

1   settled the Picowers and got $5 billion and put it

2   into the fund, that wasn't profits, that wasn't

3   stock. Mr. Picower had $5 billion of other

4   customer's money, and he gave it back. Who should

5   get that? Who should get that out of that fund?

6   Those people who did not get their money out. It's

7   as simple as that.

8   Now, once all of those people, we

9   estimate that to be around $20 billion, give or

10   take. It may be less, may be a little bit more.

11   We'll see. We're halfway home, we've collected 10.

12   Give us an opportunity to go get the rest and it's a

13   great aspiration that we'll get there, that this

14   Trustee is seeking to obtain $20 billion.

15   He then pays the $20 billion. Now

16   the two customers are on equal footing. Those who

17   got their money out and got some on top of that are

18   now equal to those who got their money out of the

19   fund of customer property. That's the goal, the

20   priority of the statute. That's what the statute is

21   all about, is that these who did not get their money

22   out get the opportunity, through the customer fund,

23   that priority. Once that priority is satisfied,

24   then all of them are on equal footing and they all

25   have a fraud claim. You're absolutely right, Your

1   Honor. At the end of the day all of them look and

2   say to us, to the Trustee, I have a claim here. I

3   thought I had 30 years worth of profits. I don't

4   have them now. What are you going to do about that?

5   Well, what this Trustee is doing and

6   what we have done is instituted suits, suits to

7   recover not just the $20 billion but the damages

8   that were inflicted by those who participated and

9   perpetuated this fraud. At the end of the day our

10 hope is that there will be a second fund, there will

11 indeed be a general creditor fund, and all of these

12 appellants here will have the opportunity then, but

13 only then, to participate.

14   Imagine, would it be fair to adopt

15 their approach and suggest that I take the $5

16 billion or, more accurately, this Trustee, and give

17 half of it to people who already got all of their

18 money back and tell the people who didn't get their

19 money back, you're not getting half of this, we're

20 giving it over here because we're using the last

21 statement?

22   The Trustee's approach here is the

23 only reasonable construction of the statute, it's

24 the only reasonable exercise of discretion.

25 Anything short of that, anything short of what I've

 1   just described leads to the absurd result, Your

 2   Honor, that you alluded to when you said the law

 3   does not countenance absurd results, the absurd

 4   result that we would be giving other people's

 5   money --

 6   JUDGE LEVAL: May I ask you a

 7   question?

 8   MR. SHEEHAN: Yes, Your Honor.

 9   JUDGE LEVAL: A somewhat different

10   hypothetical.

11   Supposing that this were not a total

12   Ponzi scheme but a partial Ponzi scheme, supposing

13   that the investment manager actually managed

14   investments very successfully, producing extremely

15   good results, perhaps not quite as good as the ones

16   Madoff purported to obtain, but good results so that

17   year after year on balance there were very

18   substantial profits but that as to some of the

19   clients -- let's say it's a common fund or funds

20   invested virtually identically for all investors,

21   and as to a certain number of the investors it was

22   fictitious because the manager, the investment

23   manager was pocketing those monies or using them for

24   other purposes, to gamble, whatever, cigars, so that

25   everybody, all the customers had identical

1 statements, all of the customers showed gradual

2 increases in profits until the day of reckoning,

3 when the whole house of cards came down. But on

4 that day it's ascertained that some of the

5 customers' statements represent entirely fictitious

6 amounts, whereas others actually have the securities

7 actually purchased for their account.

8   So, on that day, how do you account

9 to the different customers? There isn't enough to

10 go around. Do you give full value to some and only

11 the cash that they put in to the others? Or do you

12 treat them identically so that the ones who actually

13 had the securities in their accounts get less than

14 what their accounts actually had in them? How do

15 you deal with that?

16   MR. SHEEHAN: I think the answer is

17 just as Your Honor suggested at the very end of your

18 hypothetical. SIPC protects the customer for the

19 cash and securities they put into the hands of that

20 broker. And if it's converted by the broker, then

21 they get their money back.

22   So in this hypothetical that you

23 have, the cash and securities of one set of

24 customers is there, and they get that back, and they

25 should and that's what the statute mandates. But

1   what has happened to the other customers is that

2   unfortunately for them their money has been

3   absconded with. That doesn't mean at the end of the

4   day that all they get back is the cash that they put

5   in, but the fund doesn't have any additional

6   dollars, can't manufacture that, but they would be

7   entitled to, I believe, in that particular instance,

8   though, would be an advance. Unlike because I think

9   they had money in --

10   JUDGE LEVAL: SIPC.

11   MR. SHEEHAN: Yes, I think that would

12 be so. But that's not true when you're dealing with

13 an entire Ponzi scheme, and the only people that

14 could participate within that would be as we're

15 dealing with here.

16   For example, what has happened here

17 is those people who didn't get their money out,

18 which we deemed priority claimants, that are getting

19 the benefit of the fund, have already received over

20 $700 million from the SIPC fund and they will then

21 receive, on top of that, the monies from the

22 customer fund that we accumulate. That makes sense.

23 They didn't have their money back so therefore they

24 get the advance and we try, through the $700

25 million, et cetera, to pay them those monies. But

1 other than that, to give advances to people that

2 already got their money out doesn't fit under the

3 statutory scheme of trying to, going all the way

4 back to the idea, what are we trying to do here.

5 We're trying to take a specific class of customers

6 and give them priority. That's not going to work if

7 you start giving that money, the money of other

8 people. And I think that really is what determines

9 this. I really think it's so controlling here. I

10 don't think it's alien to the scheme at all. In

11 fact, I think this Trustee has embraced it.

12   JUDGE LEVAL: How do you reconcile it

13 with the obligation of the debtor, if the, as was

14 stated earlier, if the debtor owes each customer

15 what is on their statement, what the SIPA statute

16 speaks of is the obligation of the debtor, that the

17 Trustee shall promptly discharge all the obligations

18 of the debtor?

19   MR. SHEEHAN: Which is why we --

20   JUDGE LEVAL: I'm sorry, the --

21   MR. SHEEHAN: I'm sorry, Your Honor,

22 I apologize.

23   That's exactly why we have 78fff-2B.

24 You can't just use the statement.

25   Below I made a statement that caused

1   some concern among some of the appellants and that

2   is that who in their right mind would rely upon

3   these statements. That caused some concern.

4   JUDGE LEVAL: But you don't dispute

5   that those statements represent the obligation of

6   the debtor?

7   MR. SHEEHAN: No, I do dispute that.

8   I think they are one piece of evidence that

9   evidences the obligation of the debtor. That's it,

10   one piece, one of many, all of which we have to look

11   at. We have to look at the entire books and

12   records.

13   This Trustee is mandated by this

14   statute to do a complete and thorough investigation.

15   That's what he's done. And that complete and

16   thorough investigation yielded the truth that what

17   we have here is no trades, no profits.

18   JUDGE JACOBS: I'm not sure I

19   understand how the statement doesn't represent the

20   obligation of the debtor assuming, under the facts

21   that we have here, that people were permitted to

22   rely upon this and a defrauder undertook to pay them

23   that and in reliance they left their money in his

24   hands.

25   MR. SHEEHAN: I didn't say it didn't

1 represent it. I said standing alone it's not

2 determinative. You cannot just take, as Your Honor

3 said earlier --

4   JUDGE JACOBS: Standing alone it

5 would work fine at a fraud trial, it seems to me.

6   MR. SHEEHAN: At a fraud trial that's

7 true.

8   JUDGE JACOBS: Well, that's -- the

9 debtor would be Madoff Securities and at a fraud

10 trial they would be a defendant and they would owe

11 that.

12   MR. SHEEHAN: And they sure as heck

13 would and they wouldn't get any of it, because

14 Bernie would have spent it all.

15   JUDGE RAGGI: No, no, but that's a

16 separate question.

17   MR. SHEEHAN: I know that.

18   JUDGE RAGGI: And avoids or doesn't

19 address our concern, that you are asking us to

20 conclude that the obligation for SIPA purposes is

21 different from the debtor's obligation. And I speak

22 only for myself, I'm having some trouble

23 understanding why you think that that is a different

24 obligation.

25   MR. SHEEHAN: I'm not suggesting

1   that -- if you look at Article 8 that my adversary

2   relies upon, from which I think this question is

3   emanating, it says that once you have a SIPA

4   proceeding, these rules go by the board, and the

5   reason is because the SIPA rules dominate that.

6   They have to. It's a salutary statute designed to

7   provide certain relief under certain dire

8   circumstances. It isn't business as usual, it isn't

9   dealing with your broker on a daily basis. This is

10 a catastrophe and it's only in that catastrophe that

11 the Trustee can operate the way he does, by not

12 being bound by simply the statement itself, but by

13 what the statute suggests, you look beyond that to

14 the books and the records.

15   JUDGE JACOBS: Thank you.

16   MR. SHEEHAN: Thank you.

17   MR. CONLEY: Good morning. May it

18 please the Court -- it's still morning? It's

19 afternoon, actually. Michael Conley for the SEC.

20   I would like to address this morning

21 briefly why the Bankruptcy Court's ruling in this

22 case is entirely consistent with what SIPA provides

23 about how net equity claims are to be determined.

24   JUDGE JACOBS: It would help me at

25 least if you started out distinguishing your

1   position, to the extent it is distinguished, from

2   that of SIPC and/or the Trustee.

3   MR. CONLEY: Yes, Your Honor.

4   With respect to the issue that's

5   squarely presented here today, which is how is net

6   equity calculated under the statute, and whether you

7   would look solely to the final account statements as

8   the claimants are arguing, or if you look to the

9   final account statements among other books and

10   records in evidence, we are in agreement with the

11   position of SIPC and the Trustee.

12   There is a separate issue, a distinct

13   issue, which relates to whether the net equity

14   claims should be valued in constant dollars, which

15   is a position that the Commission took, does take;

16   however, the Bankruptcy Court decided in a

17   scheduling order to set that aside and to consider

18   that only after this initial determination is made.

19   And so returning to the statute, in

20   our view the Bankruptcy Court correctly rejected two

21   arguments --

22   JUDGE LEVAL: So that issue of the

23   constant dollars or the inflation-adjusted dollars

24   is not before us now?

25   MR. CONLEY: It's not, Your Honor.

1   JUDGE LEVAL: You say it hasn't been

2   decided at the Bankruptcy Court level.

3   MR. CONLEY: It has not been decided,

4   it's not been briefed and so that issue, depending

5   of course on how this Court rules, will ultimately

6   be something that would be decided.

7   JUDGE JACOBS: Are we called upon to

8   rule on that?

9   MR. CONLEY: No, you're not. And

10   again, returning to the two arguments that the

11   Bankruptcy Court rejected, I believe appropriately,

12   with respect to how SIPA works in this context, one

13   relates to that the only provision of SIPA that's

14   relevant to the net equity calculation is the

15   definition of net equity in section 16 paragraph 11;

16   and, two, that under that definition customers' net

17   equity is conclusively established simply by

18   reference to the final account statements. In our

19   view both of those contentions are wrong, and the

20   Bankruptcy Court correctly ruled so.

21   Section 1611 essentially defines net

22   equity by describing a formula for calculating it.

23   It says, in essence, that the net equity is equal to

24   what the broker owes or the broker's obligations to

25   the customer, or X, minus what the customer's

1   obligations are to the broker, or Y.

2   But what section 1611 does not do is

3   say how the broker determines what X and Y are. And

4   in order to that you look to section 8B of the

5   statute or 78fff-2B, which I refer to as 8B. And

6   that brings us back to the language that the Court

7   has spent some time focusing on.

8   It says that the Trustee is to

9   discharge all obligations of a debtor to a customer

10   relating to, or net equity claims based upon

11   securities or cash, and then the critical words,

12   insofar as such obligations, one, are ascertainable

13   from the books and records of the debtor, broker,

14   or, two, are otherwise established to the

15   satisfaction of the Trustee.

16   In our view what that means basically

17   is that under 8B the only way that a Trustee can

18   satisfy these claims, these net equity claims which

19   are based on obligations that the broker has, is if

20   the broker -- is if the Trustee is able to conclude

21   that they are ascertainable in either of those two

22   ways. And that's exactly what the Trustee did in

23   this case, he looked at the books and records and he

24   looked at the other evidence, after having conducted

25   an extensive investigation, which is also required

1 by the statute under section 7D, and found what we

2 all know to be true now.

3   JUDGE RAGGI: Let me ask you a

4 concern I have. Because there are the two different

5 maximums that can be provided, the 100,000 for cash

6 and 500,000 for securities positions, everyone -- no

7 one is disputing that what we've got here is

8 securities positions. And yet it seems to me that

9 net equity is being calculated in terms of cash.

10   MR. CONLEY: Net equity is being

11 calculated in terms of cash here, Your Honor,

12 because the Trustee concluded that that was the only

13 thing at the end of the day that was evident --

14   JUDGE RAGGI: I don't mean to scare

15 anyone by suggesting that this should be treated as

16 cash, but on the one hand that does seem to be what

17 you're calculating and concluding that you can't

18 decide what the value of the security positions is.

19 All you can decide is what's the cash they put in

20 and took out. Then why isn't this a cash position?

21   MR. CONLEY: Well, it's not a cash

22 position, Your Honor, because of what this Court

23 held in New Times. And in New Times the Court held

24 that when a customer gives cash for the purpose of

25 buying securities and then receives confirmations

1   and account statements that suggest that that's what

2   happened, the customer has a legitimate obligation

3   to believe that that's how the cash was being

4   invested.

5   JUDGE RAGGI: If that's the case, why

6   isn't the receipt of each account statement

7   something that the customer could reasonably rely

8   on? I mean, to use the old maxim, a decision to

9   hold is a decision to buy. So, you know, if you get

10   told you hold X number of shares in this account

11   statement worth such and such and you don't tell the

12   broker to do anything, you've got that reasonable

13   expectation. Why isn't that this case?

14   MR. CONLEY: I think for precisely

15   the reason that the Court ultimately, or the result

16   that the Court ultimately determined was appropriate

17   in New Times.

18   Remember, with respect to the

19   customers in New Times, the ones who were actually

20   the subject of the appeal, the ones who invested in

21   the bogus mutual funds, the Court determined two

22   things. First, that those folks had claims for

23   securities based upon their having paid money for

24   securities and gotten confirmations and statements

25   and so on. But then when it came time to calculate,

 1 well, what's the net equity, that's a different

 2 matter. The claims for securities relates to

 3 section 9A under the statute and what the maximum

 4 is, as Your Honor noted, under the SIPC fund to

 5 which they would be entitled.

 6   The net equity calculation is

 7 controlled by different provisions in the statute

 8 and this Court concluded that with respect to these

 9 bogus securities, you simply couldn't say that they

10 provided a basis for valuing, a basis for, that

11 could be liquidated or that there was any kind of

12 evidence that the Trustee could look at to say what

13 these were worth.

14   Likewise here, the Trustee, through

15 the extensive investigation and for precisely the

16 reason that Your Honor noted earlier, the sort of

17 series of historical fraud upon fraud upon fraud,

18 there was nothing there in these statements that

19 could be valued.

20   JUDGE RAGGI: But the victim of that

21 fraud is the account holder and, as I understand it,

22 you're not suggesting that any account holder didn't

23 rely in good faith on what the statement said.

24   So to that extent, the last statement

25 says that instead of holding the ten shares of AT&T

 1 he started with, he now owns 200 shares. Why isn't

 2 that a securities position that can be valued?

 3   MR. CONLEY: It's not a securities

 4 position that can be valued because it's completely

 5 detached from any reality of market trading. The

 6 only way that you get to the number that's next to

 7 the real security name is through the series of

 8 transactions, none of which actually took place or

 9 reasonably could have, because remember at each

10 stage you're coming up with fictitious profits that

11 are being used and purportedly reinvested to expand

12 the number of these real shares that you purportedly

13 own.

14   JUDGE RAGGI: What if the arrangement

15 with the client, instead of it being buy whatever

16 you think is in my best interest, had been in one

17 stock, buy it and use all dividends and whatever to

18 buy more, over a 30-year period. Would the customer

19 not have a position equal to the last statement in

20 that security?

21   MR. CONLEY: I think what you're

22 talking about here, Your Honor, is something that's

23 quite akin to the folks in New Times who weren't the

24 subject of the case, the ones who had a specific

25 investment that they believed they were being put

1   into, which were the real mutual funds.

2   JUDGE RAGGI: But with a direction

3   for constant repurchase --

4   MR. CONLEY: Exactly. And it's a buy

5   and hold kind of a situation. And I think that's

6   exactly what transpired there. And although the

7   Court didn't have to speak to it, SIPC and the

8   Trustee in that case saw that, yes, in that

9   circumstance I understood that my money was being

10   invested in a specific security, I received

11   confirmations and account statements which indicated

12   that, and I am entitled to the additional

13   reinvestment credits over time, and I would have the

14   value, I would be entitled on the filing date of the

15   liquidation proceeding to the value of that security

16   or those securities on that date. And that's

17   exactly what happened in New Times. Although as I

18   say, not the subject of appeal.

19   JUDGE JACOBS: So the distinction you

20   draw between New Times and the circumstances of this

21   case is in New Times with respect to some of the

22   people who were put into real stocks, you can,

23   looking at folks' records, account statements and

24   market prices, you can actually calculate --

25   MR. CONLEY: Precisely, Your Honor.

1   JUDGE JACOBS: -- a real number for

2 them.

3   MR. CONLEY: That's right.

4   JUDGE JACOBS: Whereas, if you have a

5 fake stock that never had any value, or if you had

6 real stock that's put through machinations and

7 transactions that are impossible, then you can't

8 calculate that value, and you're in the same

9 situation as the people in New Times who couldn't

10 recover because they had -- their holding of

11 securities was impossible to calculate.

12   MR. CONLEY: That's exactly our

13 position in this case, Your Honor.

14   I see that my time has expired.

15   JUDGE LEVAL: Furthermore, in New

16 Times, when the people who received a statement

17 showing real stocks, as to them, their account

18 showed not retrospectively, but prospectively, that

19 they were invested in these real funds, and then

20 they stayed in those funds for the entire duration

21 of the -- they stayed ostensibly for the entire

22 duration of the fraud. So that there was no

23 manipulation, there was no manipulation by the fund

24 manager of their account values, giving them

25 imaginary profits on all these different days. They

 1   just were told as of the start you've invested in

 2   this fund and what they end up with was what was the

 3   performance of that fund over all the period that

 4   they were in, which was not necessarily good or bad.

 5   It didn't reflect imaginary fluctuations of profit.

 6   MR. CONLEY: That's exactly right,

 7   Your Honor.

 8   JUDGE JACOBS: Thank you.

 9   MR. CONLEY: Thank you.

10   JUDGE JACOBS: Ms. Chaitman, we'll

11   hear rebuttal.

12   MS. CHAITMAN: My name is Helen Davis

13   Chaitman. I'm with Becker & Poliakoff, and I

14   represent approximately 500 Madoff investors.

15   Some of my clients began investing

16   with Mr. Madoff in the 1960s. Some of them started

17   investing in the 1980s. What the Trustee has done

18   is taken the position that no statement that my

19   clients received over a period of up to 50 years is

20   binding, because the Trustee, ignoring the Statute

21   of Limitations, is netting out deposits and

22   withdrawals going back 50 years. There is no basis

23   in the law to do that.

24   If you look at this Court's decision

25   in New Times the Court recognized that the purpose

1   of SIPA was to provide insurance to investors who

2   were giving up the right to certificate its

3   securities. And that insurance is limited to the

4   SIPC advance of up to $500,000 per customer.

5   You have from your questions

6   indicated that you understand that that is different

7   from the fund of customer property. It was Congress

8   that decided that a customer's net equity claim

9   would be determined for both purposes in exactly the

10 same way.

11   Congress didn't say that any SIPC

12 Trustee has the right in his discretion to determine

13 whether that's the fair way. It's not a question of

14 fair.

15   JUDGE JACOBS: Let me ask you this.

16 Suppose you have a, not a securities claim under

17 SIPA, but a cash claim. In that case wouldn't the

18 Trustee be able to go back 10, 20 or 30 years in

19 order to find out how much the proper amount of the

20 cash, this was deposited, that was withdrawn, this

21 was deposited, that was withdrawn. It could be for

22 20 years, couldn't it?

23   MS. CHAITMAN: I don't believe so,

24 Your Honor, because I think that the Trustee would

25 be bound by the last statement. And I'd like to

1   just say that with respect to section 8B it doesn't

2   contradict the definition of net equity because 8B

3   doesn't ask the Trustee to determine whether the

4   securities were ever purchased. They weren't

5   purchased for the customers in New Times where the

6   SEC and SIPC both recognized that those customers

7   were entitled to be paid the appreciated inflated

8   value of the securities, regardless of the fact that

9   the broker didn't buy them. It was never supposed

10   to be a test whether the broker purchased the

11   securities. This statute was enacted precisely for

12   a situation where the broker didn't purchase the

13   securities. That's why we have it.

14   JUDGE RAGGI: The Trustee, though,

15   takes the position with us that none of these cases

16   involved a Ponzi scheme and that the reality of a

17   Ponzi scheme, for purposes of a payout that's going

18   to be treating net equity the same whether it's the

19   customer account or the SIPA fund, is that one

20   customer's profits can only be a function of another

21   customer's loss. Do you want to respond to that

22   argument and why you don't think it ought to inform

23   our decision here today?

24   MS. CHAITMAN: I think it can't

25   inform your decision because we have a statute which

1   defines net equity as what is owed to the customer.

2   And 8B provides that the Trustee should look at the

3   books and records to determine what is owed to the

4   customer. What is owed to the customer is the

5   balance on the customer's account.

6   Mr. Ponzi lived in the 1920s. He was

7   well known to Congress in 1970 when SIPA was

8   enacted. If they had wanted to make a Ponzi scheme

9   exception, they would have put it in the statute.

10   There is no exception for a broker who decides to

11   not buy securities for all of his customers. There

12   is no exception for a broker who buys and sells,

13   rather than buys and holds. The contemplation was

14   to provide a limited amount of protection to a

15   customer, just like FDIC insurance.

16   When President Nixon signed the

17   statute into law, he said, I am signing a statute

18   which will provide to securities customers the same

19   kind of protection that the FDIC provides to bank

20   depositers. Can you imagine a liquidator of a bank

21   coming into this Court and saying, I'm only going to

22   pay up to $250,000 based on the net investment in a

23   bank deposit going back 50 years? I'm going to

24   eliminate all interest on which that depositer has

25   paid taxes? That's the situation we have here.

1   I would ask the Court to consider

2   what SIPC is really doing is saving approximately $1

3   billion because the number of customers whose claims

4   have not been allowed based on this net investment

5   hearing, who coincidentally are all the people who

6   were the long-term investors, like my 91-year-old

7   client who retired in 1970 and took mandatory IRA

8   withdrawals out of his account for 21 years. Of

9   course he took out more money than he put in. But

10   that's the purpose that people invest in the stock

11   market.

12   JUDGE JACOBS: What do you say to

13   Mr. Sheehan's argument, the Trustee's argument that

14   SIPA just provides you an advance on what you will

15   be entitled to in the bankruptcy proceedings, and

16   that in the bankruptcy proceedings there's not going

17   to be any payday based on these hypothetical

18   investments?

19   MS. CHAITMAN: The statute mandates

20   that SIPC promptly replace the securities in a

21   customer's account, not two years after $200 million

22   have been spent on forensic accountants. Promptly

23   replace the securities. The legislative history

24   indicates the purpose is, get that investor right

25   back in the stock market. This is an investor who

1 gave up the right to certificated securities which

2 benefited the Wall Street firms which were funding

3 the SIPC insurance.

4   It's not a question that SIPC doesn't

5 have the obligation to make the advance unless and

6 until it's satisfied that it will be repaid on its

7 subrogation claim. That's nowhere in the statute.

8 It's simply like any other insurance company to the

9 extent that they pay, they stand in the shoes of the

10 insured, once the insured is paid in full. But that

11 SIPC advance has to be made promptly. That word is

12 throughout the statute. And this is what Congress

13 intended. This is a remedial statute to compensate

14 victims who rely upon a broker's obligation to

15 purchase securities reflected on his statement.

16   JUDGE RAGGI: Let me ask you the

17 question that we've dealt with with other counsel,

18 too. 78fff-2B says that you pay those obligations

19 only to the extent they're ascertainable from the

20 books and records of the debtor or otherwise

21 established to the satisfaction of the Trustee.

22 When the Trustee goes into these books and records

23 he finds out that there was never any transaction

24 done on a particular day. Rather, it was post hoc

25 representations that transactions had been done in

1 order to relay profits that had never been realized,

2 and that that is not really a securities

3 transaction.

4   So, to that extent it's not finding a

5 net equity position in that. Why isn't that within

6 the Trustee's discretion?

7   MS. CHAITMAN: Because the Trustee

8 has an obligation to honor the net equity, which is

9 the obligation of the broker --

10   JUDGE RAGGI: But only insofar as

11 these two things are satisfied, that's statutory.

12   MS. CHAITMAN: There's nothing in the

13 books and records of Madoff that indicates that he

14 doesn't owe to each investor the November 30th, 2008

15 account balance.

16   JUDGE RAGGI: But what there is not,

17 though, is any transaction either conducted on that

18 day or even reported on that day. The transaction

19 is only reported after the fact and concocted

20 because it was profitable. That's different from

21 telling someone today, I bought a particular stock

22 for you, because then the customer takes the risk.

23 Here, by telling it only after the fact, there was

24 never any risk.

25   MS. CHAITMAN: Your Honor, in New

1   Times there was no evidence in the debtor's books

2   and records that the customers whose statement

3   showed existing securities, that the debtor had ever

4   purchased those securities. It's exactly the same

5   thing here. And there is nothing in this record

6   which indicates that any of the prices for the

7   securities were invalid. If someone in 1960 bought

8   IBM stock and sold it and then bought it again and

9   sold it and bought it again, it would have

10 appreciated in value. There is no reason to

11 disallow --

12   JUDGE RAGGI: That's like my telling

13 you today that ten years ago I bought Intel and then

14 I would have a huge profit in it.

15   MS. CHAITMAN: How can a customer --

16 the people standing before you invested in Madoff

17 through seven investigations conducted by the SEC of

18 Mr. Madoff over an 18-year period. If the SEC --

19   JUDGE RAGGI: There's not a

20 suggestion that your clients are in any way culpable

21 for this. The question, though, is whether or not

22 the Trustee in paying pursuant to this statute has

23 some discretion about how to calculate net equity.

24   MS. CHAITMAN: Not for purposes of

25 the SIPC payment. The SIPC payment has to be based

1 upon the last statement. There is a provision in

2 SIPA which says that SIPC cannot change the

3 definition of net equity. That's how important this

4 definition was to Congress. In order to induce

5 confidence in the capital market so that people

6 would give up the requirement of holding

7 certificated securities. And there is nothing in

8 the statute which says it only protects customers

9 who have a buy and hold strategy or customers who

10 fail to delegate to their manager or their broker

11 the right to invest in his discretion. There is no

12 limitation in the statute. So it covers every one

13 of these Madoff investors who had a legitimate

14 expectation that they owned the securities on their

15 statements.

16   JUDGE JACOBS: Thank you very much.

17   MS. CHAITMAN: Thank you.

18   JUDGE JACOBS: Thank you all. We

19 will reserve decision.

20   Please adjourn Court.

21   COURT CLERK: The Court stands

22 adjourned.

23   (Proceedings adjourned 12:36 p.m.)

24   -o0o-

25

1   C E R T I F I C A T E

2

3   I, NANCY C. BENDISH, a Certified Court

4   Reporter and Notary Public of the States of New

5   Jersey and New York, do hereby certify that the

6   foregoing is a true and accurate transcript of the

7   proceedings as taken stenographically by and before

8   me at the time, place, and on the date hereinbefore

9   set forth.

10   I DO FURTHER CERTIFY that I am neither

11   a relative nor employee nor attorney nor counsel of

12   any party in this action and that I am neither a

13   relative nor employee of such attorney or counsel,

14   and that I am not financially interested in the

15   event nor outcome of this action.

16

17

18   _____
     Notary Public of the State of New York
     Certificate No. XI00836

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