

Helen Davis Chaitman (4266)  
Phillips Nizer LLP  
666 Fifth Avenue  
New York, NY 10103-0084  
(212) 841-1320  
hchaitman@phillipsnizer.com  
*Attorneys for Diane and Roger Peskin, Maureen  
Ebel and a group of other customers*

Hearing Date: February 2, 2010  
Hearing Time: 10:00 A.M.

**UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF NEW YORK**

SECURITIES INVESTOR PROTECTION  
CORPORATION,

Plaintiff,

v.

BERNARD L. MADOFF INVESTMENT  
SECURITIES LLC,

Defendant.

SIPA Liquidation

No. 08-1789 (BRL)

In re:

BERNARD L. MADOFF,

Debtor.

**CUSTOMERS' MEMORANDUM OF LAW IN OPPOSITION TO TRUSTEE'S  
MOTION FOR AN ORDER APPROVING THE TRUSTEE'S RE-DEFINITION OF  
"NET EQUITY" UNDER THE SECURITIES INVESTOR PROTECTION ACT**

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Phillips Nizer LLP  
666 Fifth Avenue  
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**UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF NEW YORK**

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SECURITIES INVESTOR PROTECTION :  
CORPORATION, : Adv. Pro. No. 08-01789 (BRL)  
 :  
Plaintiff, : SIPA Liquidation  
 :  
v. : (Substantively Consolidated)  
 :  
BERNARD L. MADOFF INVESTMENT :  
SECURITIES LLC, :  
 :  
Defendant. :  
-----X  
In re: :  
 :  
BERNARD L. MADOFF, :  
 :  
Debtor. :  
-----X

**CUSTOMERS' MEMORANDUM OF LAW IN OPPOSITION TO TRUSTEE'S  
MOTION FOR AN ORDER APPROVING THE TRUSTEE'S RE-DEFINITION OF  
"NET EQUITY" UNDER THE SECURITIES INVESTOR PROTECTION ACT**

Phillips Nizer LLP files this memorandum of law on behalf of a group of customers (the "Customers") of Bernard L. Madoff Investment Securities LLC ("Madoff) for whom the Firm has filed objections to the Trustee's determination letters, as well as on behalf of Diane and Roger Peskin and Maureen Ebel, who are "net losers" in the Trustee's terminology but nevertheless believe that the Trustee's definition of "net equity" is a direct violation of the

Securities Investor Protection Act (“SIPA”) and is violative of their rights.<sup>1</sup> This memorandum is submitted in opposition to the motion by Irving H. Picard, Trustee, for an Order upholding the Trustee’s re-definition of “net equity” under SIPA and in opposition to the position taken by the Securities Investor Protection Corporation (“SIPC”) in support of the Trustee’s motion.

### **PRELIMINARY STATEMENT**

Reduced to its essence, the position of the Trustee and SIPC is that, because Bernard Madoff was a monstrous thief, SIPC is entitled to violate the clear mandates of the Securities Investor Protection Act, by which it was created. In the process, the Trustee and SIPC are single-handedly destroying the investor confidence in the capital markets that Congress enacted SIPA to instill.

Congress intended, through SIPA, to provide specific insurance protection to people who chose to invest their life savings through SEC-regulated broker/dealers. Over the course of its 38-year existence, SIPC repeatedly promised customers of SEC-regulated broker/dealers that, if it turned out they dealt with a thief, SIPC would promptly replace securities up to \$500,000 as reflected on the customers’ last statements. As of December 31, 2008, SIPC had assets of \$1.7 billion and it was facing a loss in the Madoff case of approximately \$2.5 billion.<sup>2</sup> SIPC had two choices: It could draw on the \$2 billion lines of credit available to it under SIPA and fulfill its statutory obligations; or it could default on its obligations, leaving thousands of defrauded and destitute Madoff investors and their families without funds to support themselves. SIPC chose to default.

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<sup>1</sup> A list of the Customers on whose behalf the Firm has filed objections is annexed to the November, 13, 2009 Declaration of Helen Davis Chaitman (“Chaitman”) as Exhibit A.

<sup>2</sup> The Trustee has announced to the public that, of the 4,903 active accounts that Madoff had as of November 30, 2008, only 2,335 customers actually lost money on the Trustee’s net investment calculation (and only 2,275 of those 2,335 actually filed claims). The account balances of all the account holders as of November 30, 2008 totaled \$64.8 billion. Thus, if successful in re-writing SIPA, the Trustee would have reduced by half SIPC’s exposure. Chaitman Exh. O. *See also*, SIPC’s 2008 Annual Report indicating that, with administrative expenses, the total Madoff loss would cost SIPC \$1.4 billion. Chaitman Exh. T at 18.

The Trustee's motion is SIPC's attempt to obtain this Court's blessing for SIPC's default of its statutory obligations. Just as the American taxpayers were required to bail out Wall Street to the tune of hundreds of billions of dollars, after Wall Street recklessly brought the global economy to its knees, so too, Madoff's destitute customers are being forced to bail out SIPC, whose members, the same Wall Street firms, enjoyed essentially free SIPC insurance during the boom years of 1996 through 2008, all the while inducing tens of millions of innocent investors to entrust their life savings to SEC-regulated broker/dealers who profited from holding the investors' securities in street name.<sup>3</sup>

SIPC has repeatedly ignored warnings from Congress that it was under-funded and would not be capable of handling a major liquidation.<sup>4</sup> Yet, when Bernard Madoff confessed on December 11, 2008, instead of drawing on the statutory lines of credit available to SIPC so that it could fulfill its obligations to the Customers, SIPC decided to deny the Customers their promised, statutorily mandated, insurance in order to enrich its own members. This has left the Customers in dire financial straits, many of whom are elderly, unwell, and unable to support themselves.<sup>5</sup>

SIPC's bait-and-switch is a violation of the express provisions of SIPA. SIPC repeatedly represented to courts and to the public that it would replace securities in an investor's account, up to \$500,000, based upon the customer's last statement. SIPC's President, Stephen Harbeck, personally represented to the court in a 2003 SIPA liquidation that, where a customer invested with a Ponzi schemer who took the customer's money and never purchased the securities

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<sup>3</sup> For the entire period from 1996 through 2008, and despite warnings from Congress that SIPC was seriously under-funded, SIPC continued to charge its members, such as Goldman Sachs, Bank of America and Merrill Lynch a token fee of \$150 per year per firm for hundreds of billions of dollars of SIPC insurance. Chaitman Exhs. T at 9, Z, AA, CC, DD.

<sup>4</sup> See Chaitman Exhs. AA and DD.

<sup>5</sup> Chaitman at ¶¶ 2-7.

reflected on the customer's statement, SIPC would replace the securities even if they had tripled in value. As Mr. Harbeck acknowledged, if customers are led to believe that "real, existing" securities had been purchased for their accounts, then those customers are entitled to get the full value of their securities positions as of the filing date, even if the securities had never been purchased:

MR. HARBECK: **Even if they're not there.**

THE COURT: Even if they're not there.

MR. HARBECK: Correct.

THE COURT: **In other words, if the money was diverted, converted –**

MR. HARBECK: And the **securities were never purchased.**

THE COURT: Okay.

MR. HARBECK: **And, if those positions triple, we will gladly give the people their securities positions.**<sup>6</sup>

In a February 26, 2003 News Release available on SIPC's website, Harbeck bragged about SIPC's prompt replacement of securities for investors in the Park South liquidation:

The Park South case is a textbook illustration of why Congress created SIPC to protect investors at troubled brokerage firms. While misuse of customer cash and securities is uncommon, it is important for investors to know that SIPC is here as a safety net when they need us in those situations. SIPC's mission also was met here in terms of making sure that more than 2,000 Park South investors were not further victimized by having their assets tied up for months or longer in a bankrupt brokerage firm.<sup>7</sup>

Just five days after Madoff's confession, on December 16, 2008, Josephine Wang, the General Counsel of SIPC, consistent with SIPC's conduct for 38 years, assured the public that a Madoff customer is entitled to the securities in his account:

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<sup>6</sup> July 28, 2000 Tr. at 37-38, *In re New Times Sec. Servs. Inc.* (B. E.D.N.Y. 2000) (emphasis added) (Chaitman Exh. E).

<sup>7</sup> <http://www.sipc.org/media/release26feb03.cfm>; emphasis added.

Based on a conversation with the SIPC general counsel, Josephine Wang, if clients were presented statements and had reason to believe that the securities were in fact owned, the SIPC will be required to buy these securities in the open market to make the customer whole up to \$500K each. So if Madoff client number 1234 was given a statement showing they owned 1000 GOOG shares, even if a transaction never took place, the SIPC has to buy and replace the 1000 GOOG shares.<sup>8</sup>

Yet, despite SIPC's repeated representations of coverage, and the representations of coverage which continue to be made to this day by SIPC's members,<sup>9</sup> all of which induced the American public to entrust their life savings to Wall Street, SIPC is taking the position in this Court – for the first time in its history – that it only insures the net investment of the investor, regardless of how long the investor had his or her account.

## ARGUMENT

### I. SIPA REQUIRES SIPC TO REPLACE SECURITIES UP TO \$500,000 BASED UPON THE BALANCE ON THE CUSTOMER'S LAST STATEMENT

Congress enacted SIPA with the specific goal of instilling investor confidence in the capital markets by insuring customer accounts against the risk that the broker either stole the customer's money and never purchased the securities reflected on the customer's statement, or stole the securities themselves. Congressman Robert Eckhardt commented when SIPA was amended in 1978:

One of the greatest shortcomings of the procedure under the 1970 Act, to be remedied by [the 1978 amendments] is the failure to meet legitimate customer expectations of receiving what was in their account at the time of their broker's insolvency.

\* \* \*

A customer generally expects to receive what he believes is in his account at the time the stockbroker ceases business. **But because securities may have been**

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<sup>8</sup> Chaitman Exh. M: December 16, 2008 Insiders' Blog, <http://www.streetinsider.com/Insiders+Blog/SIPCs+Role+In+Madoff-Of-All-Scams+Could+Save+The+Stock+Market/4243249.html>.

<sup>9</sup> See, e.g., Chaitman Exhs. R and MM.

**lost, improperly hypothecated, misappropriated, never purchased, or even stolen**, this is not always possible. Accordingly, [when this is not possible, customers] will receive cash based on the market value as of the filing date. (Emphasis added.)<sup>10</sup>

*See also, SEC v. Packer, Wilbur & Co.*, 498 F. 2d 978, 984 (2d Cir. 1974)(purpose of SIPA was to protect investors whose funds were misappropriated).

SIPC was required to “maintain and administer an insurance fund which would provide coverage against customer losses. . . resulting from broker-dealer firms’ insolvency.” S.Rep. No. 91-1218, p. 1 (1970)<sup>11</sup>. The Senate described SIPC as “an insurance plan for the industry,” and one of several “federally sponsored insurance programs.” *Id.* at 4 - 5, 7 - 9. *See also, Bell & Beckwith v. McGraw*, 937 F.2d 1104, 1106 (6th Cir. 1991)(“one primary purpose of SIPA was to provide for the establishment of a fund to be used to make it possible for the public customers in the event of the financial insolvency of their broker, to recover that to which they are entitled . . .”). In light of its function as a quasi-governmental insurance company, SIPC’s default on its obligations to the Customers is destructive not only to the Customers but to the national interests in the same way that a default by the FDIC would be devastating to the national economy.

In order to fulfill customer expectations and instill confidence in the capital markets, SIPC’s Series 500 Rules, 17 C.F.R. 300.500, provide for the classification of claims in accordance with the “legitimate expectations” of a customer based upon the written transaction confirmations sent by the broker-dealer to the customer. *See* 17 C.F.R. § 300.502. For 38 years of SIPC’s existence, a customer’s SIPC claim was determined by the brokerage statements the customer received, regardless of whether they were accurate.

Thus, it is irrelevant that Madoff perpetrated a massive fraud. The only issue in a SIPA liquidation is what was the **customer’s** “legitimate expectation.” Here, other than Jeffry Picower

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<sup>10</sup> Chaitman Exh. C: H.R. Rep. 95-746 at 21; emphasis added.

<sup>11</sup> Chaitman Exh. B.