

JURISDICTIONAL STATEMENT

This is an appeal from a Decision and Final Order of the Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”) dated March 1, 2010 (the “Decision”) and March 8, 2010 (the “Final Order”) respectively.

The Bankruptcy Court has jurisdiction pursuant to 15 U.S.C. §78eee(b)(4). This Court has jurisdiction over this direct appeal pursuant to 28 U.S.C. 158(d)(2)(A).

On March 19, 2010, Appellants Dr. Michael Schur and Mrs. Edith A. Schur (each an “Appellant” and collectively the “Schur Appellants”) filed a Notice of Appeal from the Final Order of the Bankruptcy Court (A. Vol. III, p. 727). On April 7, 2010, a Joint Petition for Permission to Appeal directly to this Court was filed and on June 16, 2010, this Court granted the petition.

The Schur Appellants have been assigned Docket No. 10-2378.

STATEMENT OF THE ISSUE ON APPEAL

The Core issue to be determined on this appeal is the proper definition of customer “net equity” under the SIPA statute, which defines net equity as “the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer...; minus (B) any indebtedness of such customer to the debtor on the filing date...” 15 U.S.C. §78lll(ii).

As will be shown at a later portion of this brief, the amount “owed by the [broker]” to the BLMIS customer is equal to the amount set forth on the final customer account statement.

Although Congress specifically prohibited SIPC from changing this statutory definition,¹ the Trustee has nevertheless adopted a new “definition”, one which limits a customer’s “net equity” only to the excess of deposits into the account over withdrawals from the account (the “Net Investment Method” or the “Trustee’s Method”), ignoring all of the transactions that had been confirmed to the customer and set forth in the monthly account statements, culminating in the customer’s final account statement.²

Despite the clear statutory language, the Bankruptcy Court sustained the Trustee’s alternative method of calculating net equity. On this Appeal, this Court should reverse that erroneous determination by the Bankruptcy Court and require that the statutory definition of net equity be used, as mandated by Congress.

STATEMENT OF THE CASE

The Schur Appellants appeal from an order dated March 8, 2010 (the

¹ See, 15 U.S.C. § 78ccc(b)(4)(A) & 15 U.S.C. § 78lll

² Moreover, in many instances, including the Appellant Edith A. Schur, the customer’s net equity was unilaterally “adjusted” downward by virtue of the Trustee unilaterally - and erroneously - disallowing various account deposits, in whole or in part.

“Order”) of the United States Bankruptcy Court for the Southern District of New York (Hon. Burton R. Lifland) based upon a memorandum Decision issued on March 1, 2010 (the “Decision) which ruled that in the SIPC liquidation of BLMIS, customer claims and net equity are to be calculated using the Trustee’s “Net Investment Method” rather than in accordance with the statutory definition of “net equity” enacted by Congress in the SIPA statute. *In re Bernard L. Madoff Investment Securities LLC*, 424 B.R. 122 (Bankr. S.D.N.Y. 2010).

Nature of the Case

This appeal arises out of the SIPA liquidation of Bernard L. Madoff Investment Securities LLC (“BLMIS”), a broker registered with the Securities and Exchange Commission (“SEC”) and a member of the Securities Investor Protection Corporation (“SIPC”), an independent, non-profit membership corporation created by SIPA.³

The proceedings were initiated on December 11, 2008, by the filing of an SEC civil complaint in the District Court for the Southern District of New York alleging that BLMIS and Madoff had operated a fraudulent investment advisory business. On December 25, 2008, the district court granted the application by

³ The individual bankruptcy of Bernard L. Madoff (“Madoff”) has been substantively consolidated with the SIPA liquidation of BLMIS.

SIPA for an order commencing a SIPA liquidation, appointing a trustee and removing the matter to the Bankruptcy Court.

In a SIPA liquidation, a customer of the broker in liquidation is entitled to receive payment in the amount of the customer's net equity, as defined by SIPA. SIPC advances such payments subject to the financial coverage limits of SIPA, in accordance with its statutory mandates which, *inter alia*, require that the Trustee satisfy customers net equity claims "promptly". SIPA imposes the financial responsibility of funding SIPC on the registered brokerage community which comprise the SIPC membership.

As noted above, the core issue on this appeal is determining the proper definition of "net equity" under SIPA for those BLMIS customers who filed timely SIPC claims, pursuant to the directions and orders of the Bankruptcy Court.

Procedural History

Pursuant to a claims procedure order entered on December 23, 2008 by the Bankruptcy Court, appellants timely filed separate written statements of claim, on the Trustee's forms authorized by the Court, for the securities and values set forth on their respective final account statements dated November 30, 2008, reflecting their respective SIPA net equity claims as defined by the statute.

In determining customer claims (including those filed by the Schur

Appellants), the Trustee ignored the final customer account statements and the SIPA definition of net equity. Instead, the Trustee determined customer net equity based on his Net Investment Method. As a result, the Trustee: (i) rejected in its entirety the claim of Mrs. Edith A. Schur; and (ii) substantially reduced Dr. Michael Schur's claim by the amount of withdrawals he had made from his account over the years and the confirmed and reported appreciation and earnings in the account.

In each instance, the Trustee made his determination based solely on the limited cash in/cash out transactions in the account, ignoring all of the voluminous reported securities transactions that had been confirmed by Madoff/BLMIS as having taken place in their accounts. Each of the Schur Appellants has filed timely objections to the Trustee's determinations which included, *inter alia*, specific objections to the Trustee's Method of calculating net equity and his failure to recognize the final account statement as the basis for determining net equity.

The Bankruptcy Court Motion and Decision

Recognizing that the proper definition and method of calculating net equity was a core and threshold issue, the Trustee sought a global determination on the lawful definition of net equity under SIPA and sought specific Court approval for his controversial Net Investment Methodology.

Both in the Trustee's application, and in the subsequent order authorizing the motion to proceed in accordance with a briefing schedule fixed by the court below, it was made clear that the sole issue to be determined was the abstract legal definition of net equity under SIPA - all rights and defenses as to all other issues were reserved. (A. Vol I, p. 264)

Nevertheless, the Trustee based much of his argument on factual assertions and the court below essentially adopted those assertions as if they had been conceded by the parties, although that was not the case. In light of the court below's order and in light of the purely legal question presented, it was inappropriate for the Trustee to make an argument based upon disputed facts - particularly in the absence of discovery and any evidentiary support or hearing.

The unauthorized submission of those factual claims was highly prejudicial. In its Decision, the court below focused on and adopted the Trustee's version of the "facts" despite its order that factual issues were not to be submitted by the parties nor would they form the basis for the determination of the legal issue presented. The court below then held that net equity under SIPA may be "susceptible to different formations" based upon "the underlying factual disparities" of the fraud - holding that the facts as presented by the Trustee lent themselves to the new method of calculating net equity which the Trustee had

proposed. In doing so, the court below violated the language of the statute, the case law interpreting the statute and ignored the expressed will of Congress.

STATEMENT OF FACTS

A. Undisputed Facts Relating to the Schur Appellants.

This appeal presents a pure question of law, based on certain undisputed relevant facts.

With respect to the Schur Appellants, the following facts are undisputed:

1. Each of the Schur Appellants was a BLMIS account customer as of the December 11, 2008 SIPC liquidation filing date. Each had previously sent money to Madoff and BLMIS to invest in securities and each has been recognized by the Trustee as a “customer” within the meaning of SIPA.
2. During the course of maintaining the accounts, each Schur Appellant made periodic deposits to and withdrawals from their respective accounts. As of the SIPA filing date, after giving effect to those deposits and withdrawals, each account had a reported final account statement balance of substantially in excess of ONE MILLION (\$ 1,000,000) dollars.
3. Over the life of the said accounts, each Schur Appellant received written trade confirmations and monthly account statements reflecting the transactions that Madoff/BLMIS represented had been executed for their respective accounts. The final account statements for each of the Schur Appellants represented the net result of the cumulative reported securities transactions over the years in their respective accounts.

4. Based on the final account statements, each of the Schur Appellants had substantial positive net equity in their separate BLMIS accounts within the meaning of SIPA, entitling each to a full \$500,000 SIPA advance and to full *pro rata* participation in the distribution of any customer property, all in accordance with the SIPA statute.
5. Nevertheless, because the Trustee utilized the Net Investment Method rather than the SIPA definition, the Trustee determined their respective SIPC claims as follows:
 - i. The Trustee rejected *all* claims for the delivery of physical securities.
 - ii. The Trustee denied Mrs. Edith Schur's SIPC claim in its entirety.
 - iii. The Trustee allowed a portion of Dr. Michael Schur's claim but in a significantly reduced amount, reflecting a total disallowance of the confirmed securities and related transactions.
6. The Trustee has not claimed (nor is there a basis to claim) that either of the Schur Appellants was aware of the fraud perpetrated by BLMIS and Madoff prior to the public disclosure of the fraud. For purposes of this motion, each Schur Appellant must be deemed an innocent victim of the fraud. Each will be harmed by the use of the Trustee's Net Investment Method rather than the SIPA statutory definition.

B. Disputed Facts Presented as “Undisputed” by the Trustee.

Although it should have been irrelevant to the Bankruptcy Court's

determination of the legal definition of net equity, the Trustee injected the factual claim that “it is undisputed” that no securities transactions ever took place and no profits were ever generated for the Madoff/BLMIS customers. But that is neither conceded, established nor undisputed. Indeed, even based on the available public record,⁴ it is virtually undisputable that there *were* voluminous securities and related transactions which generated, at a minimum, hundreds of millions of dollars in real profits and income using the customers’ funds, specifically for the customers’ accounts.

Based upon the Madoff related criminal charges that have been made public,⁵ it now appears that the customer funds were, in fact, earning substantial income on a daily basis in bank and securities accounts held and earmarked by Madoff/BLMIS specifically for the investment customers. Solely by way of example, a Southern District of New York Grand Jury recently returned a lengthy indictment against three key ex-Madoff employees. The indictment discussed in detail the various BLMIS bank accounts and the income each generated. With respect to the Investment Advisor (“IA”) customer bank and securities account, the indictment significantly alleges the following:

⁴ Claimants have not been allowed any discovery.

⁵ This Court may take judicial notice that this indictment has been publicly filed. *Singh v. U.S. Dept. of Homeland Security*, 526 F.3d 72 (2nd Cir. 2008).

BLMIS Finances

A. The Principal Bank and Brokerage Accounts of BLMIS and MSIL

50. Billions of dollars of funds received from IA clients were deposited principally into, and the funds to fulfill requests from IA client for withdrawals from their BLMIS accounts were obtained principally from, a bank account most recently maintained in New York, New York (“Bank No. 1”) (the “IA Account”) and a checking account that was maintained at Bank No. 1 that was affiliated with the IA Account (the “IA Checking Account”).

51. The end-of-day balances in the IA Account - balances which were generally in the hundreds of millions of dollars during the 2001 - 2008 period - were swept into a variety of overnight deposit accounts (the “IA Sweep Accounts”). In addition, beginning in or about 2007, in excess of approximately \$1 billion was invested in U.S. Treasury bills and other similar investments and was custodied in a separate account that BLMIS maintained at Bank No. 1. (The above described BLMIS accounts held at Bank No. 1 are collectively referred to as the “BLMIS IA Accounts”). Interest earned on those accounts was generally transferred to the IA Account on a regular basis.

* * *

53. At all times relevant to this Indictment, BLMIS also maintained brokerage accounts at a variety of financial institutions (the “IA Brokerage Accounts”). Funds in the IA Brokerage Accounts were generally invested in U.S. government-issued securities such as U.S. Treasury Bills.”

Moreover, based upon other statements that have been made public, including the SEC Inspector General's jailhouse interview of Madoff, it appears that Madoff's fraud did not begin until as late as the early to mid-nineties and then only with respect to a small percentage of the monies he controlled. It apparently was not until later that his fraud grew to encompass all or most of his IA customers. The Trustee has, however, made no distinction between these different time periods and flatly asserted - without providing evidence or discovery - that from inception Madoff *never* made *any* trades and all reported transactions and profits were, therefore, fictitious and to be disregarded under his methodology.

In addition, it is not disputed that Madoff also operated as a large market maker as well as a proprietary trader for his own account. Further, these market making and proprietary trades appear to have included shares of the very same S&P 100 companies that BLMIS was confirming to the customers were being traded for them. It is likewise not disputed that these trades - which used his customers' funds - generated substantial profits. Even the Trustee concedes that all of Madoff's operations took place within one single Madoff entity.⁶ Thus, it is a semantic sophistry to assert that there were no actual securities trades or profits.

⁶ From 1960, when Madoff began operations, until December 2000, Madoff conducted business as a sole proprietor. In December 2000, BLMIS was formed and all business activities were conducted by BLMIS.

Trades were made and profits generated daily in substantial amounts. The Trustee has simply chosen not to recognize or credit any to the customer accounts even though the law imposes a duty on a broker to execute orders for customers first, before executing orders for the house.

Unfortunately, without *any* evidentiary basis and in the absence of *any* discovery, the Court below accepted the Trustee's unsupported factual assertions and, in large part, based its Decision upon them.

* * *

Even in the absence of discovery, it is becoming more and more clear that the Trustee's "undisputed" facts will not hold up to scrutiny. Thus, even if the Trustee and the court below were correct that a fraud in which no transactions ever occurred and no profits were ever generated should give rise to the Trustee's new definition of net equity - the actual facts of this case do not fit into that scenario and the Trustee's new definition should not apply in any event.

As set forth below, SIPA does not contain more than one definition of net equity. There is no provision for varying definitions and calculations based upon different factual scenarios. This appeal properly presents a pure question of law and should properly be determined solely on the law, without reference to any extraneous contested, disputed or untested factual claims.

SUMMARY OF ARGUMENTS

The decision and judgment of the Bankruptcy Court sustaining the Trustee's Net Investment Method definition of Net Equity (a) violates, the clear SIPA statutory definition of Net Equity; (b) is contrary to controlling case law in this circuit; (c) defies the express congressional purpose of fostering investor confidence in our capital markets and meeting reasonable customer expectations; and (d) is contrary to prior judicial representations and admissions made by SIPC concerning the definition of Net Equity and the scope of protection afforded defrauded investors under the SIPA statute.

- (A) The SIPA statute provides no authorization, or justification, for the Trustee's artificial Net Equity definition. Not only is there no mention of such a methodology in SIPA but the express statutory definition is wholly inconsistent with such a methodology.
- (B) The Decision below is contrary to controlling case law in this Circuit, particularly as set forth in the seminal *New Times Securities* case. In *New Times*, this Court affirmed, in clear and unambiguous language, that when (as here), a defrauded customer receives written trade confirmations and monthly account statements from the customer's brokerage firm purporting to report and record transactions in real

securities in the customer's account, that customer's SIPA net equity is what the customer's final account statement says the broker owes the customer, consistent with the customer's reasonable expectations.

Although acknowledging that *New Times* was controlling, the Bankruptcy Court simply paid lip service to it, while essentially ignoring or distorting virtually everything the *New Times* Court said and the legal principles it set forth.

- (C) The legislative history reveals two main Congressional purposes behind SIPA:
- (1) Congress enacted SIPA to protect the reasonable expectations of investors (the Trustee's Method virtually insures that those reasonable investor expectations will be thwarted);
 - (2) Congress passed SIPA to foster investor confidence in our capital markets (the Trustee's Method threatens to destroy that hoped for confidence as investors come to understand that— as construed by SIPC and its Trustee- SIPC actual coverage and protections are more illusory than real).

The Trustee's Method seeks to undercut the statute so that SIPC may protect its (and the securities industry's) financial interests at the expense of the investor protections that Congress provided.⁷ The Bankruptcy Court

⁷ SIPA's motives are not difficult to understand: the Trustee's Method will save SIPC (and ultimately the securities industry) substantial sums of money- money which congress earmarked for the benefit of defrauded investors, not to be hoarded by SIPC or to avoid assessing

should have forcefully rejected the Trustee's efforts. Instead, the Bankruptcy Court provided judicial approval for what is, essentially, a judicial repeal and re-writing of SIPA, stripping away the legislative protections that Congress clearly mandated.⁸

By allowing SIPC to disclaim its otherwise clear liability, the Bankruptcy Court has sanctioned a result which is in direct conflict with what Congress intended when SIPA was enacted. If allowed to stand, the necessary impact will be an effective repeal of the protections Congress intended SIPA to provide to investors when a brokerage firm fails and must be liquidated by SIPC.

Further, the Trustee's Method undercuts the second goal of SIPA - to foster investor confidence in our capital markets. The Trustee's Net Equity construct will have precisely the opposite result, creating the specter of chaos and disruption in the securities marketplace as investors come to the

the securities industry.

⁸ This violates basic Constitutional principles of separation of powers. The proper role for the courts is to insure that the statute is enforced as written by Congress. It is not the court's role functionally to amend a statute to suit its subjective views and preferences nor was it proper for the court below to allow a quasi-public agency (SIPC), or its designated Trustee, to revise the statute and eliminate fundamental statutory protections, in order to address SIPC's internal financial concerns.

realization that SIPA does not protect them in any meaningful way.⁹

The Trustee's "definition" functionally shifts the financial burden of loss resulting from broker failure from the brokerage industry, as Congress intended, to the defrauded investor, as if SIPA had never been enacted. If the Decision below is sustained by this Court, the message will be all too clear: investors will act at their peril if they continue to deal trustingly with their brokerage firms, no matter how large or seemingly reputable those firms appear to be.

(D) The Bankruptcy Court also gave short shrift to the multiple past representations and admissions made by SIPC - including judicial representations/admissions to this Court- that when investors received trade confirmations and account statements reflecting transactions in real securities, with ascertainable real market place values, those reported transactions would be given full force and effect by SIPC - and that SIPC would either replace the securities *in kind*, or, if that was not feasible, make payments to the defrauded customers for the values of securities reflected in the accounts, up to the dollar limitations of SIPA. Those prior

⁹ In fact, it actually will expose them to dramatic clawback liability simply for using what they reasonably understood was their own money to pay their living expenses over the years.

representations and admission should have been given conclusive effect as a matter of logical persuasion. Indeed, they are binding on SIPC as a matter of law, under fundamental principles of judicial estoppel. Bluntly, SIPC should have been held to its prior representations and admissions. Instead the Court below simply ignored them as if they had not been made and had not been part of SIPA's definitional history.

* * *

In sum, the lower court's decision was erroneous for a variety of reasons, each individually sufficient to compel a reversal. Any fair reading of the SIPA statute, particularly if read in conjunction with the stated Congressional purpose and legislative history of SIPA, the controlling case law in this circuit and SIPA's prior representations on the subject can lead to but one conclusion: the Bankruptcy Court was wrong to approve the use of the Trustee's Net Investment Method of defining net equity in place of the statutory definition. Accordingly, on this appeal, the Court should replace the Trustee's defective and unauthorized construct with the definition that SIPA plainly requires-use of the customer's final account statement - consistent with the statutory language, the applicable case law and the dual congressional purposes of satisfying reasonable customer expectations and fostering investor confidence in the capital markets.

STANDARD OF REVIEW

This Court reviews *de novo* the Bankruptcy Court's legal conclusions, including its legal interpretation of SIPA and the legal definition of "net equity". See, *In re Flanagan*, 505 F.3d 171,179 (2d Cir 2007); *Pereira v. Farace*, 413 F3d 330, 341 (2nd Cir. 2005).

ARGUMENT

POINT I

THE TRUSTEE'S METHOD OF CALCULATING NET EQUITY IS IMPROPER AND MUST BE REVERSED

A. The Trustee's Method is Contrary to the Clear Definition of Net Equity Set Forth in the SIPA Statute.

It is a fundamental, indeed cardinal, rule of statutory construction that if a statute is clear and unambiguous, it must be applied as written. It may not be altered or modified under the guise of "interpretation".

As explained by the United States Supreme Court :

Courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then this first canon is also the last: 'judicial inquiry is complete.'

Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 253-54 (1992).

The SIPA statute contains an explicit definition of net equity. It is written

in direct and plain English. It's meaning is clear. Accordingly, "judicial inquiry is complete" and the statute must be applied as written.¹⁰

SIPA defines "net equity" as "the sum which would have been owed by the debtor

to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer..." 15 U.S.C. § 78111(11). Thus, net equity equals what the brokerage firm would owe the customer if the brokerage firm were not in liquidation and the customer closed his or her account. *In Re Adler Coleman Clearing Corp*, 247 B.R. 51, 62 (Bkrcty. S.D.N.Y. 1999) ("Net equity is calculated as the difference between what the debtor owes the customer and what the customer owes the debtor on the date the SIPA proceeding is filed"). *See also, In Re Investors Center, Inc.*, 129 B.R. 339(Bkrcty. E.D.N.Y. 1991).

Brokers are required by law to provide account statements to their customers so that the customer may be informed of the activity in the account and the customer's current securities positions. *See, e.g.* Rule 10b-10, 17 C.F.R. 240.10b-10; NASD Rule 2340. Under SIPA and its associated rules, these confirmations are enforceable on behalf of the customer. SIPC Series 500 Rules,

¹⁰ Significantly, Congress prohibited SIPC from changing certain terms defined in the SIPA statute, reserving that prerogative only to Congress. "Net Equity" is one of those defined terms. 15 U.S.C. § 78ccc(b)(4)(A) & 15 U.S.C. § 78 111.

17 C.F.R 200.500 *et seq.* (Written trade confirmations received by the customer from the broker will be enforced in accordance with their content, as reflecting the “legitimate expectations of customers”).

In the instant case, it is not disputed by the Trustee that each transaction attributed to a BLMIS customer account - each reported securities purchase and sale - was specifically confirmed in writing to the customer and incorporated as well in the written monthly account statements reaffirming the representations made in those individual trade confirmations.¹¹

Therefore, on a liquidation of a BLMIS customer’s account, that customer would clearly have been entitled to receive from BLMIS the securities that BLMIS represented were contained in the account and/or the full value reflected in the final customer account statement - which is the culmination of all of the previous account statements and trade confirmations. *See, e.g., Visconsi v. Lehman Bros., Inc.*, 244 Fed. Appx. 708, 2007 WL 2258827 (6th Cir. 2007); *see also, In re New Times Securities Services, Inc.*, 371 F.3d 68 (2nd Cir. 2004); *In re Adler Coleman; In re Investors Center, Inc.* Manifestly, customers are entitled to rely on those

¹¹ Each confirmation and account statement contained the SIPC logo and the representation that BLMIS was a member of SIPC. Thus, each customer reasonably believed that his or her investment account was protected up to the dollar limits of SIPA, in the event BLMIS failed.

confirmations and account statements and the issuing brokers are bound to honor their statements as a representation of what the broker owes the customer. This result is consistent with, indeed mandated by, the plain SIPA statutory language defining net equity.

Further, under Article 8 of the New York Uniform Commercial Code, when the broker acknowledges that it is carrying a securities position for a customer, the customer obtains an entitlement to those securities positions even if the broker does not actually possess them. New York UCC§8-501(c). Indeed, it is,

a basic operating assumption of the [street name system of holding securities] that once a [broker] has acknowledged that it is carrying a position in a financial asset [e.g. securities] for the customer... the [broker] is obligated to treat the customer... as entitled to the financial asset [the securities]

Official Comment. NYUCC § 8-501(2).

In short, the customer's rights against the broker to receive the securities that the broker has confirmed it is holding for the customer "do not depend on whether or when the securities intermediary [the broker] acquired its interests." *Id.* §8-501(3). Rather the customer's rights flow from what the broker has represented and acknowledged it holds for the customer. *See, e.g., In re New Times Securities Services, Inc.; Visconsi v. Lehman Bros.; SEC v. Zandford*, 535 U.S. 813, 819 (2002).

Thus, as between the broker and the customer, when a broker confirms that securities are in the customer's account, the customer is entitled to possession and has a valid and enforceable claim against the broker for those securities. There is no exception - under the New York U.C.C. or SIPA - simply because the broker lied and the securities were not purchased by the broker.

Since the customer owns - and has the right to receive from the broker - securities listed in the customer's account statement, the final account statement represents what the broker owes the customer. Under the statutory definition, that is the customer's "net equity" for SIPA purposes.

Not surprisingly, the Trustee's Method is nowhere to be found within the SIPA statute. The Trustee's Method ignores completely what the Broker owes the customer- even though that is the precise SIPA definition of net equity.¹²

Since the SIPA statute is clear on its face, and, by its terms, requires net equity to be computed in accordance with the contents of the customer's final account statement, it was error for the Bankruptcy Court to ignore the plain statutory definition and to allow the Trustee to calculate it instead on the basis of

¹² As set forth below, the Trustee's Method does not comport, in any way, with the Congressional intent underlying SIPA. Indeed, the necessary effect of the Trustee's Method is to insure that customer's reasonable expectation will *not* be met and that the investing public will be made *substantially more apprehensive* about entrusting money to the brokerage industry and the capital markets.

his own subjectively preferred definition nowhere to be found in the statute.

B. The Trustees Method is Contrary to Controlling Case Law in this Circuit.

The Trustee's Method violates the controlling case law in this and other federal jurisdictions. A prime example is the leading case of *In re New Time Securities Services, Inc.*, 371 F.3d 68 (2nd Cir. 2004).

New Times Securities involved a Ponzi scheme perpetrated by an individual named William Goren. The relevant facts were summarized by this Court as follows:

From approximately 1983 until 2000, through New Times and New Age, Goren defrauded hundreds of Long Island and Queens New York investors out of approximately \$32.7 million. Goren's scheme was multifaceted. He solicited customers of New Age and New Times to invest in (i) one or more non-existent money market funds (often called the New Age Securities Money Market Fund), (ii) shares of bona fide mutual funds (from e.g., The Vanguard Group, and Putnam Investments) that were never in fact purchased, and (iii) fraudulent promissory notes issued by Goren and/or New Age. Instead of investing these customers' funds as represented, Goren misappropriated the money.

New Times Securities, 371 F.3d at 71-72.

As noted by the Court, the fraud in *New Times* involved two distinct categories of confirmed securities transactions: (i) those relating to bona fide

existing mutual funds and (ii) those relating to non-existent funds.

Recognizing this as *the* crucial distinction, both SIPC and the Courts gave full force and effect to *all* of the confirmed transactions in the bona fide funds - including all appreciation in value reflected in the confirmations and account statements, even though the transactions had not actually taken place.

[I]nvestors that were misled by Goren to believe that they were investing in mutual funds that in reality existed were treated much more favorably [than those who were led to invest in the fictitious funds]. Although they were not actually invested in those real funds- because Goren never executed the transactions- the information that these claimants received on their account statements ‘mirrored what would have happened had the given transactions been executed’ Br. For Appellants [SIPC Trustee and SIPC]. As a result, the Trustee deemed those customers claims to be ‘securities claims’ eligible to receive up to \$500,000 in SIPC advances. The Trustee indicates that this disparate treatment was justified because he could purchase real, existing securities to satisfy such securities claims. Furthermore, the Trustee notes that, if they were checking on their mutual funds, the ‘securities claimants’ in contrast to the ‘cash claimants’ bringing this appeal could have confirmed the existence of those funds and tracked the funds’ performance against Goren’s account statements.

Id. at 74.

Both the SIPC Trustee and the Court reached the opposite conclusion, however, when addressing the rights of investors who had confirmations of

transactions in wholly fictitious mutual funds. Although determining that these investors had “securities claims” - because the money they gave Goren was for the specific purpose of purchasing securities - the Court limited their claim to the customer’s net investment, without giving effect to the alleged transactions in totally fictitious securities.

The Court explained the basis for this disparate treatment:

To be clear— and this is the crucial fact in this case - the New Age Funds in which the Claimants invested *never* existed. They were not organized as mutual funds, they were never registered with the SEC and they did not issue any of the requisite prospectuses for investors.

Id. at 74.

The Trustee noted, and the Court acknowledged, those who thought they had purchased real mutual funds could have checked and “confirmed the existence of those funds and tracked the funds’ performance against Goren’s account statements.” *Id.* at 74. That was not true for those investors in the totally fictitious New Age funds. Those investors had no source to check to confirm either the existence of the fund or to track the reported performance of the fund - and, as the Circuit Court explained, that is “the crucial fact in this case”. *Id.* at 74.

In the instant case, the Trustee does not dispute that the transactions confirmed by BLMIS in the various trade confirmations and account statements,

involved real securities. The customers could thus confirm the existence of the securities. They could track their investments to confirm that the values contained in the BLMIS confirmations and account statements were appropriately priced. The customers had a reasonable and legitimate basis to understand what their account was worth - and what they could prudently afford to withdraw and spend based on the remaining value in their BLMIS account. Under such circumstances, *New Times Securities* confirms that their allowed net equity was equal to the customer's account statement balance.

Also on point is *In re Investors Center, Inc*, 129 B.R. 339 (Bkrtcy. E.D.N.Y. 1991). The Trustee in that SIPC liquidation was also Irving H. Picard, the Trustee in the BLMIS liquidation. In that case, as in BLMIS, the Trustee sought to disavow the impact of written confirmations and account statements sent by the debtor to the customers. In a sharply-worded opinion critical of the positions asserted by the Trustee, the Bankruptcy Court, in clear and unambiguous language, held that, when written confirmations are given to a customer for transactions in real, existing securities, those confirmations are binding and conclusive for purposes of determining a customer's claim under SIPC.

The relevant facts were summarized by the Court as follows:

Before the Court are objections by a number of customers of Investors Center, Inc.... to the determinations made by Irving H. Picard Esq. as Trustee for the liquidation of the business of Investors Center pursuant to [SIPA}. Also before the Court are motions by the Trustee to confirm his determinations. The critical facts as to each of the objecting customers, or claimants, are virtually the same. In each case the claimants received a written confirmation, ...that certain stock belonging to the claimant had been sold. In each case the Trustee has nevertheless held that each claimant only has a 'claim for securities' not a 'claim for cash' under SIPC Rule 500, 17 C.F.R. § 300.500-300.503. The securities are either worthless, or nearly worthless, and each claimant is asking that his claim be recognized as one for cash in the amount of the confirmed sale. Some claimants also placed sell orders for which they never received written confirmation and which they also want to have recognized as entitling them to cash. *** At the same time as Investors Center was falsely claiming purchases, it was not executing sales orders confirmed by their representatives.

In Re Investors Center Inc., 129 B.R. at 340-341 and 346.

With respect to those investors who had received written confirmations of the transactions, the Court held that the confirmations were conclusive and binding, even though the broker “was not executing the sale orders confirmed by their representatives.” *Id.* at 346.

Under [the SIPC] rules each of the objecting claimants, because of the receipt of written confirmation of a sale...

has a claim for the [proceeds of sale] and not for securities and the Trustee's determination otherwise is incorrect

Id. at 341.

The Court then went on to explain:

It is undisputed that each of these claimants received *written confirmation* from the Debtor's clearing agent that the securities in question had been sold for, or purchased from, the customer's account. Each of these creditors, therefore, comes squarely within the [SIPC] provisions defining when a customer has a claim for cash. The Rules are as binding on the Trustee and on SIPC as they are on the public. The Trustee is not free to ignore them or rewrite them.

Id. at 341 (emphasis in original).¹³

The *Investors Center* court reached the opposite conclusion regarding claimants who had ordered their securities sold but had never received a written confirmation of sale. As to those investors, the Court felt constrained to limit their relief to receiving the stock that they had ordered sold.

[I]nsofar as [these investors] rely on sales for which they never received confirmation, they are not entitled to [the proceeds from sale]. The Trustee's determination that each has received what he is entitled by the return of the securities each tried to sell, must be sustained....

¹³ The Court also stated that "[t]he customers here involved all have claims under the Securities Investors Protection Act because each one received written confirmation of a sale." *Id.* at 351.

Id. at 353.

The significance of a receiving a written confirmation - and the impact of the absence of such a confirmation - is further demonstrated by the opinion in *In re Oberweis Securities*, 135 B.R. 842 (Bkrcty. N.D. Ill. 1991).

In *Oberweis*, a customer sought to receive the dividends that would have been earned on moneys that should have been invested by the broker but were not. In rejecting the customer's claim, the *Oberweis* court stressed that the determinative fact was that the customer never received a written confirmation for that transaction:

The [customers] also argue, based on the legislative history, Congress intended SIPA to satisfy customers legitimate expectations. Therefore, the [customers] assert that since they expected to receive dividends their claim for dividends should be allowed. *However, [they] never received confirmation that the securities were in fact purchased. The court agrees with the trustee's argument that Congress did not intend to treat customers without confirmations the same as those with confirmations; that customers with confirmations have a legitimate expectation of receiving securities but customers without confirmations do not have the same expectation.* Thus, [the customers] claim for dividends they would have received had their investment instructions been followed must be denied as a matter of law *for lack of a confirmation.*

Id. at 846, n. 1 (emphasis added).

Here , the Trustee acknowledged that: (a) BLMIS issued written confirmations to the customers for each transaction as well as account statements reflecting the various securities transactions; and (b) all confirmed transactions were in real securities. As the foregoing authorities confirm, the existence of those written confirmations and account statements govern the result and compel the conclusion that the BLMIS customer net equity is to be determined by those written confirmations and account statements.

See also, Visconsi v. Lehman Bros., 244 Fed. App. 708, 2007 WL 228827 (6th Cir.2007), a non-SIPA case which, nonetheless, is instructive on the analysis of “reasonable customer expectations” - the core guiding principle of SIPA.

The Plaintiffs in *Visconsi* were victims of a securities Ponzi scheme perpetrated on them by a broker employed by Lehman Brothers and a predecessor firm. Those victims, like the BLMIS victims here, received written account statements purporting to represent what was in the customer’s account. Those account statements, like those received by the BLMIS customers purported to reflect transactions in real securities which in fact had not occurred.

Lehman Bros. argued that the *Visconsi* victims should be limited to a “cash in/cash out” recovery methodology as does the Trustee here. The Court rejected Lehman’s arguments as inconsistent with the legitimate and reasonable expectations

of the investors.

Plaintiffs gave \$21 million to [the broker], not to hide under a rock or lock in a safe but for the express purpose of investment, with a hope - indeed a reasonable expectation - that it would grow. Thus the out of pocket theory which seeks to restore to Plaintiffs only [their investment] less their subsequent withdrawals is a wholly inadequate measure of damages.

Id. at 713

Significantly, the Sixth Circuit took specific note of the fact that the plaintiffs received statements from Lehman reflecting substantial profits in their accounts. Declaring that “[p]laintiffs thus could have reasonably believed they were entitled to the full...balance shown”, the Court flatly rejected *Lehman’s* out of pocket theory as “wholly inadequate”. That logic and analysis apply with equal force to the BLMIS investors.

Thus, if a customer received written confirmation from the broker that a transaction in real securities that exist and could have been actually purchased has occurred, the transactions reflected in the confirmations will be given full force and effect. This is consistent with Congressional mandate and reasonable customer expectations - even if the broker lied to the customer and never actually executed the transactions confirmed to the customer. *New Times Securities; In re Oberweis Securities*. See also, H.R. Rep. 95-746, 95th Cong., 1st Sess. (1977) at 21. See also,

S.Rep. 95-763, 95th Cong.2d Sess. (1978) Sess.(1978) at 2.

As noted in *New Times Securities*, there is a narrow exception to the basic rule that written confirmations govern even if the confirmed transaction has not actually occurred. But that exception applies only with respect to alleged transactions in *fictitious* securities - securities the existence of which a customer could not confirm in the market place and account values that a customer could not check against real world reported prices. In that limited circumstance, the customer has to know that any “value” ascribed to the security by the broker is necessarily subjective and arbitrary and, as such, the customer could not reasonably have relied on the value arbitrarily fixed by the broker. Therefore, the courts have carved out this narrow exception where the “transactions” involve fictitious securities and concluded that by using the customer’s net investment was the best proxy to reflect what the broker owes the customer.

What the Trustee seeks by this motion to accomplish is to treat the narrow exception to the rule as if it were the rule, ignoring, in the process, the clear language of the statute and the relevant cases that have interpreted it. It is undisputed that BLMIS customers, like the Schur Appellants, received written confirmations of transactions in real world, *bona fide* existing securities. As such, their net equity is reflected by the balance of their last account statement.

The Trustee's proffered definition of net equity is contrary to the controlling case law in this circuit. That same case law requires the use of the final account statement to determine net equity. The Order appealed from must be vacated and reversed.

C. The Trustee's Method of Calculating Net Equity is not Supported by the Legislative History and Undermines the Explicit Congressional Purposes Underlying SIPA.

Even if, *arguendo*, it is assumed that the statutory definition of net equity is, is some measure, ambiguous - which it is not - nevertheless reference to the legislative history and the expressed Congressional purposes confirm that final account statement method is the proper way to define net equity.

1. The Legislative History Supports Using the Final Account Statement to Determine Net Equity.

When Congress enacted SIPA and the amendments to it, Congress was quite aware that when a brokerage firm failed, securities acknowledged by the broker as belonging to the customer might be unavailable for a variety of causes including specifically that they were never actually purchased by the broker. Congress consciously chose to have SIPA coverage for the customer in that circumstances for the securities and values reflected in the customer's account as of the filing

date.

As the House Report concerning SIPA explains:

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 lost, improperly hypothecated, misappropriated, *never purchased* or even stolen, this is not always possible. Accordingly, when the customer's claims for a particular stock exceed the supply available to the trustee in the debtor's estate, then customers, generally receive pro rata portions of the securities claims, and as to any remainder, *they will receive cash based on the market value as of the filing date....*"(Emphasis added)

H.R. Rep. 95-746, 95th Cong., 1st Sess. (1977) at 21. See also, S.Rep. 95-763, 95th Cong.2d Sess. (1978) Sess.(1978) at 2.¹⁴

The Senate Report makes the same core point- that SIPA does cover customer losses when securities are "unavailable" because the broker lied and never purchased the securities for the customer:

Under present law, because securities belonging to customers may have been lost, improperly hypothecated, misappropriated, *never purchased* or even stolen, it is not

¹⁴ In his statement to Congress, recorded in the House Report at H.R. Rep. 95-746, at 39, SIPC'S then Chairman, Hugh F. Evans, expressly acknowledged that "customers generally expect to receive what is in their accounts when the member stops doing business." Further, he confirmed that if it is not possible to provide the customers with the actual number of shares of the stocks in the account statement "because securities have been lost ... *never purchased* or even stolen" the investor will get a pro rata distribution of shares "and he will receive cash in lieu of stock based on the market price on the date the liquidation proceeding is initiated." (Emphasis supplied)

always possible to provide customers that which they expect to receive, that is, securities which they maintained in their brokerage account ... By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the amendment not only would satisfy the customers' legitimate expectations, but would also restore the customer to his position prior to the broker-dealer's financial difficulties." S.Rep No. 763, 95th Cong., 2d Sess. (1978) at 2.

These reports and statements clearly support using the customer's last account statement to define net equity - regardless of whether actual securities were ever purchased. This directly contradicts the Trustee's argument and the ruling of the court below.

2. The Trustee's Method is Contrary to the Legislative History and the Purpose Underlying the Enactment of SIPA.

SIPA was enacted by Congress in response to a crisis in confidence which had developed in the securities markets. During the mid to late 1960's, the brokerage industry experienced a staggering number of brokerage firm failures causing substantial investor losses which, in turn generated great mistrust and impaired investor confidence in the financial and capital markets.

The loss of investor confidence in the integrity of the Capital Markets was of great concern not only to the industry, but to Congress as well. As a result, at the

urging of the securities industry, in 1970 Congress enacted SIPA for the express purpose of providing investor protection and restoring shattered investor confidence.

As explained by this Court:

Congress enacted SIPA in 1970, in response to ‘a rash of failures among securities broker-dealers in the late 1960's’ that had resulted in ‘significant losses to customers whose assets either were unrecoverable or became tied up in the broker-dealers’ bankruptcy proceedings’ The statute ‘was designed to effect two aims.’ First, the legislation immediately established ‘a substantial reserve fund... [to] provide protection to customers of broker-dealers... to reinforce the confidence that investors have in the U.S. securities markets.’ Second, SIPA ‘strengthened ... the financial responsibilities of broker-dealers.’ Later amendments to the statute have reiterated this emphasis on investor protection.

New Times Securities Services, Inc, 371 F.3d 68 at 84 (*quoting, Sec. Investor Prot. Corp. v. BDO Seidman, LLP*, 222 F.3d 63,66 (2nd Cir. 2000) and H.R. REP NO.91-1613 at 2-4 (1970), *reprinted* in 1970 U.S.C.C.A.N. 5254,5257).

One perceived Congressional need was to foster “public willingness to entrust assets to the securities industry” S. Rep. No. 763, 95 th Cong. 2d Sess 2 (1978). Recognizing that this could only happen if customers were assured that if they deposited or left their securities with their broker, in street name, they would

be protected, Congress amended SIPA in 1978 to do precisely that:

By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the amendment not only would satisfy the customers' legitimate expectations, but would also restore the customer to his position prior to the broker-dealer's financial difficulties.

S.Rep No. 763, 95th Cong., 2d Sess. (1978) at 2.

As then SIPC Chairman Hugh F. Evans explained when he appeared before congress, "customers generally expect to receive what is in their accounts when the [SIPC] member stops doing business." House Report at H.R. Rep 95-746. *Accord:* S.Rep 95-763, 95th Cong. 2d Sess.(1978) at 2. In the case of the BLMIS customer, *only* the final account statement method of calculating net equity will satisfy that reasonable customer expectation "to receive what is in their accounts when the members stops doing business."

The Trustee's Method literally insures that the customer's reasonable expectations will be thwarted. Customers will *not* get what the account statement says they own. Moreover, those aggrieved customers face the prospect of staggering claw back claims - because over their many years investing with Madoff, they innocently withdrew what they had every reason to believe was their own money to pay their living expenses - their mortgages, their taxes, the cost of

educating their children and all of the other costs of everyday life.

The Trustee's Method will hardly instill investor confidence in the capital markets. It will, instead, inform customers at every brokerage firm that they *cannot rely on anything* they receive from their brokers - not written trade confirmations and not account statements. That is an invitation to market chaos, not investor confidence. It would effectively overrule existing industry practice, agreements and regulations relating to customer reliance on the integrity of written trade confirmations and account statements.¹⁵

Moreover, the relevant SIPC rules flatly declare that the written transaction confirmations received by customers will be enforced, in accordance with their contents, as reflecting the "legitimate expectations of customers". See, SIPC Series 500 Rules, 17 C.F.R. 300.500 *et seq.* By way of example, Rule 502 provides that:

Where the Debtor held cash in an account for a customer, the customer 'has a claim for securities' with respect to any authorized securities purchase: (1) if the Debtor has sent a written confirmation to the customer that the securities in question have been purchased for or sold to the customer's account

Under the Trustee's approach, all confirmed transactions other than actual

¹⁵ In that regard, the standard industry customer agreement invariably provides that unless timely challenged, confirmations and account statements are to be given full force and effect, both by the customer and the brokerage firm.

external deposits into, and withdrawals from, the account, would be rendered nullities (as would the customer agreement provisions relating to the binding effect of written transaction confirmations).¹⁶ Essentially, all of the applicable rules, regulations and industry practices concerning the binding effect of confirmations would become obsolete - all for the singular purpose of allowing SIPC to avoid paying customers the SIPC advances that their account statements - and their reasonable and legitimate expectations - entitle them to receive.

The Trustee's Method would change all of the ground rules concerning reasonable investor expectations. Investors will no longer be able to view the SIPC-insured account as safe or protected. It will replace certainty with doubt and fear not only of loss on the account but potential claw back liability. Even after a customer withdraws funds from his or her brokerage account, that customer will remain uncertain whether, in the future, those funds will have to be paid back - because his previously highly-regarded SIPC insured broker turned out to be a thief.

¹⁶ It would induce prudent investors either to avoid our securities markets entirely or to demand that every security purchased be registered in the investor's name with the certificate physically delivered to the investor. This would cause massive back office issues for the industry similar to those that existed pre-SIPA (not to mention the elimination of an entire segment of the industry that relies on the availability of street name securities to function). All securities transactions would be substantially delayed, causing great inconvenience. The industry would incur substantial processing costs and delays. SIPC would cease to serve a function as a source of fostering investor confidence.

If the Trustee in BLMIS is permitted to do this to innocent BLMIS customers, guilty of no more than using their own brokerage account funds to pay their living costs, then every future trustee will undoubtedly follow suit. No customer will ever be secure in knowing what he has in his account and whether he has a major potential claw back liability that was unimaginable when the customer opened his account.

Who would choose to do business with a broker under those circumstances? Who would rely on SIPC insurance coverage if it did not protect basic customer expectations as evidenced by confirmations for real securities from registered brokerage firms? What could be more damaging to investor confidence in the securities market than a rule that fails to honor confirmed transactions and avoids SIPC coverage for those transactions if the brokerage firm later fails?

Nothing could be more at odds with the Congressional purpose when it enacted SIPA.

3. Other Considerations Requiring Rejection of the Trustee's Method.

Under SIPA, the cost of financing SIPC investor protection was to be borne by the brokerage industry. But, for years, the cost to the individual brokerage firms for the significant right to advertise that the firm was a “member of SIPC” was *de*

minus - only \$150 per year per financial institutions, including our largest such institutions each earning billions annually.

Needless to say, such nominal fees were not enough adequately to fund SIPC so that it properly discharge its obligations to SIPC. Given the statutory authority granted by Congress to assess the SIPC members for any shortfall in what SIPC needs, one would have expected SIPC to turn to the industry to seek sufficient funding, even if belatedly. But instead, SIPC and its Trustee conveniently crafted a *new* definition of net equity, one which will allow the industry to continue to shirk its statutory responsibilities at the expense of thousands of innocent investors, many of whom have literally been rendered destitute because of the Madoff fraud. They all had legitimate expectations that they would, at a minimum, receive their promised SIPC payments if their brokerage firm failed and had to be liquidated. For SIPC to withhold those payments from them is both shocking and unacceptable. This is intolerable. It also violates the law.

SIPC's view of what the investors have lost is at odds with the view of the IRS which, in a tax context, was addressing that same issue. Losses from a Ponzi scheme are properly characterized as deductible theft losses under the Internal Revenue Code. In calculating the amount of the theft loss, the IRS allows an investor to include not only his or her principal investment but the taxable

appreciation in the account on which taxes were reported and paid. Thus, the IRS acknowledges that an investor lost what the investor thought was in the account, not simply the net of cash in over cash out. Conceptually, one would think that an investor's theft loss under the Code would reasonably dovetail with an investor's SIPA net equity since each is intended to reflect what the investor should have received but did not. But under the Trustee's Net Investment approach, the investor is treated much more harshly by SIPA than by the IRS (an agency that has not historically been accused of being overly taxpayer friendly).

There is also the matter of the impact on the federal treasury. SIPC payments reduce the amount of the taxpayer's theft loss along with any other recovery payment received. Any time SIPC avoids paying a valid SIPC payment, in addition to the larger harm inflicted on the customer, the IRS also suffers fiscally because the amount of that investor's theft loss does not get reduced by the avoided SIPC payment. Thus the treasury is forced to assume a portion of the industries SIPC obligations as well.

It is also instructive to contrast how an investor under identical circumstances fares under the Trustee's proposed definition of SIPA net equity

versus how that same investor would fare under FDIC coverage.¹⁷

Assume hypothetically that a long time BLMIS customer had deposited \$100,000 in an FDIC insured bank fifteen years ago, at the same time the customer invested the identical amount with BLMIS. Assume further that each year the customer withdrew all interest earned on the bank account and all appreciation/profits from the BLMIS accounts and that by December, 2008 the customer had withdrawn from the bank and from the BLMIS account more money in the aggregate than the customer had originally invested. Finally, assume that in December 2008, it was disclosed that the bank's president had been involved in a massive Ponzi scheme dating back at least 15 years and as a result, the bank failed and had to be liquidated.

Under FDIC insurance, the depositor would clearly receive \$100,000, the amount that the customer's account statement said was still on deposit with the bank. FDIC would not claim - would not dare to claim - that since the depositor had already taken withdrawals of interest aggregating in excess of the original deposit, the depositor would be treated as having no money on deposit and would be entitled to no FDIC insurance coverage or payment. But that is precisely the

¹⁷ SIPC does not insure a customer against market value losses. Other than that exception, which is not relevant to the BLMIS customers, the insurance coverage under SIPA and under FDIC should be the same.

result that the Trustee is urging under SIPC's insurance. This core conflict between these two intertwined investor protections cannot be justified. The FDIC provides the investor with protection, as congress intended. The Trustee's contrived definition of net equity under SIPC will not..

It is ironic to say the least for the Trustee to characterize certain BLMIS customers, like many of the Appellants, as "net winners" when they have obviously lost so much in a real world sense - and, in many cases, they have everything they thought they had. The Trustee ignores that real world when he suggests, by his proposed definition, that the SIPC claims of these victims should be reduced by withdrawals of moneys made by those customers from their BLMIS accounts which they used to pay taxes, their mortgages, educate their children and cover all of the expenses of living that people need to pay for from the assets they believed they possessed.

In the real world, people like the BLMIS customers make spending decisions at least in part based on the remaining assets they understand they have, whether in a bank or in a brokerage account like BLMIS. These customers had every reason to believe they were spending their own money, not someone else's. They had every reason to believe that the account balances they maintained represented real assets of theirs as well. It is unseemly to effectively treat them as thieves - which is

ultimately the effect of the Trustee’s wrongful net equity definition. To interpret a remedial statute designed to protect investors in such a draconian manner is fundamentally wrong. It also violates both the letter and the spirit of SIPA.

* * *

The Trustee’s proposed net equity definition must be rejected. Net equity must be determined on the basis of the customer account statement, as required by the SIPA definition, consistent with reasonable customer expectations and the expressed intent of Congress.

POINT II

JUDICIAL ESTOPPEL PRECLUDES THE TRUSTEE FROM ASSERTING HIS NET INVESTMENT THEORY WHICH IS CONTRARY TO THE DEFINITION OF NET EQUITY URGED PREVIOUSLY BY SIPC AND ITS TRUSTEE

The doctrine of judicial estoppel prevents a party from asserting a factual position in a legal proceeding that is contrary to a position previously taken by that party in a prior legal proceeding. *Bates v. Long Island Railroad Co.*, 997 F.2d 1028, 1037 (2nd Cir.), *cert. denied*, 510 U.S. 992, 114 S.Ct. 550 (1993). In *Bates*, the Second Circuit, after reviewing earlier authorities, said that “judicial estoppel protects the sanctity of the oath and the integrity of the judicial process.” *Id.*, 997 F.2d at 1037. This doctrine has been repeatedly recognized in this Circuit. *See*,

e.g., *Bridgeway Corp. v. Citibank*, 201 F.3d 134, 141 (2nd Cir.2000); *Mitchell v. Washingtonville Central School District*, 190 F.3d 1, 6 (2nd Cir.1999); *Simon v. Safelite Glass Corp.*, 128 F.3d 68, 71-73 (2d Cir.1997); *Maharaj v. Bankamerica Corp.*, 128 F.3d 94, 98 (2nd Cir.1997); and *AXA Marine and Aviation Insurance (UK) Limited v. Seajet Industries, Inc.*, 84 F.3d 622, 628 (2nd Cir.1996).

In applying the estoppel doctrine, a court engages in the following analysis:

First, the party against whom the estoppel is asserted must have argued an inconsistent position in a prior proceeding; and second, the prior inconsistent position must have been adopted by the court in some manner.

Bates, 997 F.2d at 1038.

Both of these elements are present here.

Specifically, in *New Times Securities*, both SIPC and the SIPC Trustee asserted precisely the opposite position regarding the definition of net equity than the one that the BLMIS Trustee (and SIPC) now urge this Court to approve. As noted above, *New Times Securities* involved confirmed transactions in both real/existing securities and in fictitious securities. SIPC and the *New Times* Trustee represented to the court in formal brief submissions that a proper interpretation of SIPA required that a distinction be made in the treatment of those claimants who received confirmations of transactions involving the real securities and those who

received confirmations of transactions in fictitious securities

- With respect to confirmed transactions in real securities, the Trustee and SIPC told the Court that the basic rule required recognition of the transactions reflected in written confirmations and account statements in determining a customer's allowable SIPA claim;
- It was only with respect to claimants who received confirmations concerning transactions in wholly fictitious securities, that the Trustee and SIPC urged the Court to adopt an exception to the rule and disregard the confirmations involving make believe securities.

In urging the use of a different rule for fictitious securities, SIPC and the Trustee explained in their brief to the Second Circuit why confirmed transactions in real securities must be honored :

Reasonable and legitimate claimant expectations on the filing Date are controlling even where inconsistent with transaction reality. Thus, for example, where a claimant orders a securities purchase and receives a written confirmation statement reflecting that purchase, the claimant generally has a reasonable expectation that he or she holds the securities identified in the confirmations and therefore generally is entitled to recover those securities (within the limits imposed by SIPA even where the purchase never actually occurred and the Debtor instead converted the cash deposited by the claimant to fund that purchase.

New Times, SIPC Brief at 23-24.

The brief then noted with approval that “this emphasis on reasonable and legitimate claimant expectations frequently yields much greater ‘customer’

protection than would be the case if transaction reality, not claimant expectations were controlling”. *Id.* at 24.

In addition to the positions asserted to the Court in its brief, SIPC, through its President Stephen Harbeck, responding to questions from the Bankruptcy Court judge in *New Times*, made the following transcribed representations:

Harbeck: ...if you file [a timely SIPC claim] you’ll get the securities without question. Whether-if they triple in value, You’ll get the securities... *Even if they’re not there.*

Court: *Even if they’re not there.*

Harbeck: Correct.

Court: *In other words, if the money was diverted, converted-*

Harbeck: *And the securities were never purchased.*

Court: Okay.

Harbeck: And if those positions triple we will gladly give the people their securities positions.

Tr. at 37-39, *In re New Times Securities Services, Inc*, OO-8178 (Bkrcty. E.D.N.Y. July28, 2000) (emphasis added).

The *New Times* court specifically adopted SIPC’s dichotomy of treatment contentions for real versus fictitious securities (enforcing the confirmations for the former and disregarding them for the later).

As this Court explained:

To be clear - *and this is the crucial fact in this case* - the New Age Funds in which the claimants invested *never existed*.

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

This core principle was so familiar and well settled that within days of the Madoff scandal surfacing, SIPC general counsel Josephine Wang was quoted to the same effect, as follows:

[I]f 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 a Madoff client ... 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.

Insiders' Blog December 16, 2008, www.occ.treas.gov/ftp/alert/2008-37.html.

Quite apart from the formal application of the judicial estoppel doctrine, SIPC's judicial acknowledgments and its other public statements confirming the obligation to recognize confirmed transactions in existing securities are, at a minimum, highly persuasive and probative on the issue of the proper definition of net equity. Given these court holdings, and the specific admissions of SIPC and its

ranking officials, it is more than somewhat disquieting for SIPC and the Trustee to now urge that the basic historical rule should be ignored in the BLMIS case simply because, a proper application of the rule will require SIPC (and the securities industry) to pay substantially more money than they apparently wish to pay. SIPC's current position - first articulated in February 2009, more than three months after the scandal broke - is an artificial, *ex post facto* construct designed to protect the pocketbook of SIPC and the brokerage industry at the expense of the true victims here and is wholly without merit.¹⁸

* * *

In sum, SIPC's current proposed definition of net equity is in direct contradiction to the definition that it previously represented to this Court was the correct definition in cases such as *New Times*. SIPC's success in persuading this Court to adopt SIPC's proffered dichotomy of treatment between confirmed transactions involving real and fictitious securities cannot be ignored or disavowed now simply because SIPC finds it in its pecuniary interest to take a contrary position in the BLMIS liquidation. Application of judicial estoppel to preclude the

¹⁸ Moreover, since the hallmark of SIPA and the purpose behind it is to protect a customer's "reasonable expectations" it would be inequitable in the extreme to change the definition of the reasonableness of those expectations after both SIPC and the courts (including the Second Circuit) have indicated that "reasonable expectations" equal the balances on account statements arising from confirmations of real securities.

Trustee and SIPC from taking this contrary position would protect not only the integrity of judicial proceedings as noted in *Bates*, but would also serve to protect the integrity of SIPA and further the protections and purposes for which it was enacted

The Trustee’s newly constructed net equity definition, which is directly contrary to the position SIPC asserted in *New Times*, must be firmly rejected by this Court.

POINT III

AVOIDANCE LAW DOES NOT JUSTIFY THE DECISION

In the interests of avoiding undue repetition, we respectfully incorporate by reference POINT VI of the Davis Polk& Wardell LLP brief (also entitled “Avoidance Law does not justify the Decision”) which contains an excellent analysis of the issues with supporting legal authorities and citations. _

CONCLUSION

For the reasons set forth above, the Schur Appellants respectfully urge that this Court reverse the Order of the Bankruptcy Court and direct that the net equity of the BLMIS customers is to be determined by the final account statement method, consistent with the SIPA definition that net equity equals what the broker owes the customer as of the filing date.

Dated: New York, New York
August 9, 2010

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