Testimony of Helen Davis Chaitman, Esq. Before the
Subcommittee on Capital Markets, Insurance, and Government
Sponsored Enterprises
House Financial Services Committee
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Chairman Kanjorski and distinguished Representatives, I thank you for this opportunity to testify today. In the past year, I have become an avid student of the Securities Investor Protection Act ("SIPA") and painfully knowledgeable about the deficiencies in the performance of the Securities Investor Protection Corporation ("SIPC") under the Act.

I am an attorney practicing law in New York and New Jersey. On the evening of December 11, 2008, I learned that I had lost my life savings in Bernard L. Madoff Investment Securities, LLC. When I recovered from my shock and devastation, I realized that I was one of the lucky ones, because I am still practicing law and able to support myself. I devoted the next six months of my life to working, on an entirely *pro bono* basis, for the hundreds of destitute Madoff victims who were in their 70's, 80's and 90's and who had lost their sole means of support.

At the present time, I represent over 200 families of Madoff investors. In addition, entirely on a *pro bono* basis, I have sought both tax and SIPA relief for Madoff investors who, unlike me, no longer have the capacity to work and who, unlike me, are subject to clawback. In the past few months, I have met with many of you and with your aides and I thank you, on behalf of all my clients, for the time and attention you have given to the issues I have raised.

My clients are typically people who had invested in Madoff for 15 – 20 years; who had worked hard during the productive years of their lives; sold their businesses;

invested the proceeds in Madoff; and retired on the income they derived from their Madoff investments. Some of my clients had served with distinction in the Second World War and in the Korean War. Most of my clients were generous with philanthropies and with their children. These are Americans of whom we should all be very proud. They are living at the most fragile time of their lives. Many of them are dealing with cancer and other life-threatening illnesses. They should not have to wake up every day terrified that they will now lose the meager funds they have left. Yet, that is the way they are living.

On December 11, 2008, they were hit with a financial tsunami from which they can never recover. I know that this Subcommittee has focused on the failure of the SEC to uncover Madoff's fraud and that is not the subject of my comments. However, it is one thing for my clients to have suffered as victims of a crime. It is quite another for them to be further devastated by the failure of SIPC to comply with the mandates of a federal statute. As a result of the improper conduct of SIPC, my clients have been devastated by two additional financial tsunamis after December 11, 2008 and it is on these that I want to focus my comments today.

Tsunami 2: SIPC's Failure to Honor its Insurance Obligations to Investors

The second tsunami that devastated Madoff investors was the failure of SIPC to honor its statutory obligation to replace securities in their accounts up to $500,000.

Congress enacted SIPA in 1970 in order to instill confidence in the capital markets by establishing SIPC which would function, like the FDIC, but would be

funded by the brokerage industry.[1] I cannot imagine that there was more of a need to instill public confidence in the capital markets in 1970 than there is today. In light of SIPC's status as a quasi-governmental insurance company, SIPC's default on its obligations to the Madoff customers is destructive not only to the customers but to the compelling national interest in stabilizing the capital markets, in the same way that a default by the FDIC would be devastating to the national economy.

In 1978, the amount of SIPC insurance was fixed at $500,000 for securities and $100,000 for cash and those amounts have not been increased since 1978, despite the significant increase in the cost of living since then.[2] Many of my clients would be fully compensated if SIPC fulfilled its statutory obligations. For other clients, while the $500,000 would not have made them whole, it would have allowed them to support themselves on an interim basis and saved them the tragedy of disposing of houses at liquidation values in a tremendously distressed market.

The legislative history of SIPA makes clear that Congress' intent was to protect a customer's "legitimate expectations," based on his brokerage statements and to replace securities even if the broker stole the customer's money and never purchased the securities. For example, Congressman Robert Eckhardt commented when SIPA was amended in 1978:

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[1] "The intention of SIPC, like the FDIC, is to minimize losses to and to maintain public confidence in the institutions the public deals with." S. Rep. 91-1218, at 9, *reprinted in* Federal Securities Laws Legislative History 1933-1982, Vol. IV, at 4641. According to the FDIC's website, "It is the FDIC's goal to make deposit insurance payments within two business day[s] of the failure of the insured institution." http://www.fdic.gov/consumers/banking/facts/payment.html.

[2] The purpose of SIPC was 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). 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

> 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.
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> 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 this is not possible, customers] will receive cash based on the market value as of the filing date.

H.R. Rep. 95-746 at 21.

SIPC's Series 500 Rules, 17 C.F.R. 300.500, enacted pursuant to SIPA, 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.

Up until the Madoff case, both SIPC and the SEC acknowledged that an investor who invested in an SEC-regulated broker who operated a Ponzi scheme is entitled to replacement securities up to $500,000, even where the broker never purchased the securities and even though the securities, on paper, might have tripled in value. The controlling factor is the "legitimate expectations" of the customer; not whether the broker was a crook. In fact, in the *New Times* case, a long-running Ponzi scheme in which the broker never purchased the securities indicated on the customers' statements, Stephen Harbeck, the President of SIPC, assured the bankruptcy court that SIPC would replace securities in investors' accounts, even where the securities had

tripled in value, despite the fact that no securities had ever been purchased for the investors. [3]

Consistent with Harbeck's representation to the bankruptcy court, in the Second Circuit both SIPC and the SEC assured the Court of Appeals in *New Times* that SIPC would replace securities in a customer's account so long as the customer's statements reflected the purchase of securities. SIPC wrote in its Second Circuit brief:

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

Br. of Appellant SIPC at 23-24 (citing *New Times*)(emphasis added).

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[3] HARBECK: . . . if you file within sixty days, 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.,* No 00-8178 (B.E.D.N.Y. 7/28/00) (emphasis added).

In an *amicus curiae* brief in the *New Times* case, the SEC wrote:

> Our view [is] that when possible, SIPA should be interpreted consistently with a customer's legitimate expectations based on confirmations and account statements. [4]

The Second Circuit's two decisions in *New Times* are directly controlling in the Madoff case because the precise issue of how to treat customers, like the Madoff investors, was approved by the Court, with the agreement of the SEC and SIPC.

As late as December 16, 2008 – five days after Madoff's confession, SIPC's general counsel, Josephine Wang, assured the public, through a statement to the press, that a Madoff customer is entitled to the securities in his account:

> 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.

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

Yet, shortly thereafter, SIPC decided to violate the clear mandates of SIPA and its own representations to investors for 38 years by reneging on its insurance obligation to the victims of Madoff's fraud.

Without legal authority, Picard has invented his own definition of "net equity"

SIPA mandates that a customer's claim in a SIPA liquidation be fixed at the customer's "net equity." SIPA defines "net equity" as the value of the securities positions in the customer's account as of the SIPA filing date, less any amount the customer owes the debtor.

[4] Br. of the SEC, Amicus Curiae, In Partial Support of the Position of Appellants and In Partial Support of the Position of Appellees at 13, *New Times I* (No. 02-6166).

> The term 'net equity' means the dollar amount of the account or accounts of a customer, to be determined by –
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> (A) calculating 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
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> (B) any indebtedness of such customer to the debtor on the filing date . . .

15 U.S.C. § 78*lll*(11).

SIPA specifically prohibits SIPC from changing the definition of "net equity." 15 U.S.C. § 78ccc(b)(4)(A). The Second Circuit has recognized that:

> Each customer's "net equity" is "the dollar amount of the account or accounts of a customer, to be determined by calculating 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" [corrected for] any indebtedness of such customer to the debtor on the filing date.

In re New Times Securities Services, Inc., 371 F. 3d 68, 72 (2d Cir. 2004). [5]

In derogation of his obligations to carry out the provisions of SIPA, the trustee chosen by SIPC in the Madoff case, Irving Picard, has invented his own definition of "net equity." Picard has asserted that he has a right to recognize investors' claims only for the amount of their net investment, disregarding all earnings in their accounts. By this procedure, Picard would reduce the total Madoff claims from $64.8 billion to approximately $21 billion and he would reduce the number of customers entitled to SIPC insurance from approximately 4,904 account holders to 2,335 account holders.

[5] *See also,In re Adler Coleman Clearing Corp.*, 247 B.R. 51, 62 N. 2 (B.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.").

The 2,569 account holders whose claims are thereby eliminated include a significant multiple of 2,569 people because many accounts include the life savings of several elderly, long-term Madoff investors whose families pooled their savings in order to meet Madoff's minimum investment amount. Many of my clients had family accounts in which parents and their siblings, children and grandchildren pooled their funds. Under SIPA's definition of "customer," each of these family members is entitled to SIPC insurance, although Picard and SIPC have denied coverage to all of them.[6]

Harbeck has offered the following justification for inventing a new definition of "net equity." He says:

> Using the final statements created by Mr. Madoff as the sole criteria [sic] for what a claimant is owed perpetuates the Ponzi Scheme. It allows the thief . . . Mr. Madoff . . . to determine who receives a larger proportion of the assets collected by the Trustee.

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[6] 15 U.S.C. § 78lll(2)("The term "customer" includes . . . any person who has deposited cash with the debtor for the purpose of purchasing securities."). *Rosenman Family, LLC v. Picard*, 401 B.R. 629, 635 (B.S.D.N.Y. 2009)("the mere act of entrusting . . . cash to the debtor for the purpose of effecting securities transactions . . . triggers customer status. . ."); *SEC v. Ambassador Church Financial Devel. Group, Inc.*, 679 F. 2d 608, 614 (6th Cir. 1982); *In re Primeline Sec. Corp.*, 295 F. 3d 1100, 1107 (10th Cir. 2002)("SIPA does . . . protect claimants who try to attempt to invest through their brokerage firm but are defrauded by dishonest brokers . . . If a claimant intended to have the brokerage purchase securities on the claimant's behalf and reasonably followed the broker's instructions regarding payment, the claimant is a 'customer' under SIPA even if the brokerage or its agents misappropriate the funds"); *Miller v. DeQuine (In re Stratton Oakmont, Inc.),* 2003 WL 22698876 at *3 (S.D.N.Y. Nov. 14, 2003)("Stratton Oakmont's conversion of Claimants' property makes the customers within the meaning of SIPA.").

Clearly, if Congress had intended to limit customers to account holders the definition of customer could have been six words: "A "customer" is an account holder." Instead, Congress' definition of "customer" is 20 lines long and is further clarified in 15 U.S.C. § 78fff-3(a) to make clear that customers of a bank or broker or dealer that invests in Madoff are all customers under SIPA ("no advance shall be made by SIPC to the trustee to pay or otherwise satisfy any net equity claim of any customer who is a broker or dealer or bank, other than to the extent that it shall be established . . . that the net equity claim of such broker or dealer or bank against the debtor arose out of transactions for customers of such broker or dealer or bank . . . , **in which event each such customer of such broker or dealer or bank shall be deemed a separate customer** of the debtor")(emphasis added).

Harbeck's statement is a rationalization of what appears to be SIPC's goal, *i.e.*, to save money for the brokerage community at the expense of innocent investors who relied upon the assurance of SIPC insurance to invest their funds in Wall Street.

After almost 12 full months of his tenure, Picard has identified only two Madoff investors who **might not** have had a "legitimate expectation" that the trade confirmations and account statements they received were accurate. Picard has sued two Madoff customers, Stanley Chais and Jeffry Picower who, Picard has alleged, took out of Madoff $7.2 billion more than they invested. Picard has further alleged that these two investors received returns in their accounts of 100% – 900% and that Madoff back-dated $100 million losses in their accounts. Assuming these allegations are true, Chais and Picower were Madoff's co-conspirators and certainly could not have had a "legitimate expectation" that their accounts were genuine.

However, the fact that two people may have been Madoff's co-conspirators does not justify SIPC's depriving thousands of totally innocent investors of their statutory maximum payment of $500,000 in SIPC insurance. My clients received monthly statements from Madoff in the past several years indicating returns on their Madoff investment in the range of 9 – 11% per year, all taxable at the highest rate as short term capital gains. My clients had entered into standard brokerage agreements with Madoff, a licensed SEC-regulated broker-dealer, pursuant to which they received on a monthly basis trade confirmations for every securities transaction in the Account which accurately set forth the names and prices of securities indicating the purchase and sale of Fortune 100 company stocks and the purchase of US Treasury securities.

There is no basis to claim that my clients did not have a "legitimate expectation" that the assets reflected on the account statements sent to them by Madoff belonged to them.

Moreover, as indicated by the legislative history, the focus of SIPA is not on the state of mind of a broker who turns out to be a crook; it is on the legitimate expectations of customers who relied on the promise of SIPC insurance as reflected on every statement they received from their broker. Only by that focus can confidence be instilled in the capital markets.

SIPC's Motivation for Violating the Law

There is only one reason why SIPC has violated the clear mandates of SIPA. SIPC's and Picard's conduct saves Wall Street about $1.5 billion in SIPC insurance. Clearly, from the perspective of the Wall Street firms, they have already realized the economic benefit of SIPA because hundreds of billions of dollars of American's savings were poured into street name securities held by Wall Street because of the promise of SIPC insurance.[7] And, for 38 years, Wall Street was able to profit handsomely from those street name securities, without sharing any of those profits with the owners of the securities. SEC regulations allow brokerage firms to treat street name securities as their own property. They can lease them out; they can sell them and buy them back; they can borrow against them for their own corporate purposes. [8] The only protection for the investors is SIPC insurance.

[7] *See An Investor's Guide to the Alternatives of Holding Physical Certificates*, published by the Securities Industry and Financial Market Association, available at http://www.sifma.org/services/publications/pdf/PhysCertGuide2alternatives.pdf (stating that the Securities Industry and Financial Market Association "strongly supports and encourages [street name] type of ownership".

[8] *See, e.g.,* 17 C.F.R. 240.8c-1; 17 C.F.R. 15c-1.

Congress pointed out to SIPC that its failure to appropriately assess the Wall Street firms for SIPC insurance left SIPC incapable of handling a major liquidation. Despite warnings from the GAO and from the House Financial Services Committee, [9] SIPC persisted during the entire period from 1996 – 2008 to charge a mere $150 per year to each firm for hundreds of billions of dollars of SIPC insurance. Thus, Goldman Sachs paid $150 per year for the privilege of printing on tens of billions of dollars of trade confirmations that the customers' accounts were insured up to $500,000 by SIPC.

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[9] For example, the GAO wrote in April 2003:

> the SIPC fund was at risk in the case of failure of one or more of the large securities firms. SEC found that even if SIPC were to triple the fund in size, a very large liquidation could deplete the fund. Therefore, SEC suggested that SIPC examine alternative strategies for dealing with the costs of such a large liquidation. SIPC management agreed to bring this issue to the attention of the Board of Directors, who evaluates the adequacy of the fund on a regular basis.

July 2003 United States Accounting Office Report to Congressional Requesters, "Securities Investor Protection: Update on Matters Related to the Securities Investor Protection Corporation."

In their August 11, 2003 letter, Reps. Frank, Kanjorski and Dingell declared that they were "deeply troubled by th[e] state of affairs" at SIPC outlined the GAO Report. Specifically, the SEC had found in an examination of SIPC that:

> (1) some statements in SIPC's brochure and Web site might overstate the extent of SIPC coverage and mislead investors; (2) there was insufficient guidance for SIPC personnel and trustees to follow when determining whether claimants have established valid unauthorized trading claims, one. . principle source of investor complaints; (3) SIPC had inadequate controls over the fees awarded to trustees and their counsel for services rendered and their expenses; (4) SIPC lacks a retention policy for records generated in liquidations where SIPC appoints an outside trustee; and (5) the SIPC fund was at risk in the case of failure of one or more of the large securities firms.

Reps. Frank, Kanjorski and Dingell stated that this situation was "totally unacceptable and [they] urge[d] SIPC to fix these shortcomings, which [they] consider[ed] to be significant, with all deliberate speed before a major problem occurs." Now, the "major problem," foreseen by the SEC has come to pass in this case, and SIPC's failure to remedy its shortcomings has resulted in SIPC's fund being inadequate.

If we accept Picard's position that SIPC is only liable to replace securities up to $500,000 **per account**, there were 4,904 active Madoff accounts on December 11, 2008 on which SIPC had an exposure of approximately $2.5 billion. As we know, SIPC did not have assets of $2.5 billion on December 11, 2008. It only had assets of $1.7 billion. SIPC had two choices following December 11, 2008:

(a) SIPC could have complied with the law and borrowed up to $2 billion on its lines of credit with the SEC and the Treasury so that it would have the funds necessary to replace securities in each customer's account up to $500,000. Or

(b) SIPC could default on its obligations to Madoff's customers, thereby causing untold tragedy to innocent investors whose lives had already been devastated by the SEC's failure to close Madoff down in 1992.

This second choice is virtually unthinkable because it is such a flagrant violation of the express provisions of SIPA. And yet this is what SIPC did. SIPC announced – for the first time in its history – that, even if a customer's statements reflected the purchase of real securities, SIPC only insured the "net investment" of each customer.

By this device, the Trustee reduced the number of Madoff customers eligible for SIPC insurance from 4,904 to 2,335 account holders, leaving 2,569 account holders without the SIPC insurance to which they are absolutely entitled. And as to the 2,335 account holders who are indisputably entitled to SIPC insurance, SIPC has inexcusably delayed payment to these investors. In fact, it is now one year since Madoff was put into liquidation and the Trustee was appointed. And after one year, SIPC has only allowed 1,637 of the 2,335 account holder claims that SIPC admits are valid.

This is hardly the prompt replacement of securities that Congress mandated in SIPA or the prompt replacement of securities of which Stephen Harbeck bragged in a February 26, 2003 News Release available on SIPC's website:

> 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.[10]

I want to be very clear on something: SIPC and Picard have absolutely no legal authority for the position they are taking in the Madoff case. There is not a single case involving a SIPA liquidation in the 39 years of SIPC's history in which a court held that SIPC could utilize its net investment calculation against investors whose statements reflected the purchase of real securities. Instead, SIPC and Picard are relying on decisions of some courts in non-SIPA Ponzi scheme cases where the courts, unrestricted by a comprehensive statutory scheme like SIPA, have held that the equitable way to distribute the debtor's assets is to limit each investor to his net investment.

However, I must tell you that, in a recent decision in the Southern District of New York, **with the SEC's support**, the claims of investors in a non-SEC regulated firm which operated a Ponzi scheme were fixed at the investors' net investment **plus undistributed earnings.** In *SEC v. Byers*, 2009 WL 2185491 (S.D.N.Y. July 23, 2009), the Court's only consideration in approving the plan of distribution was whether the plan was "fair and reasonable" because it was not a SIPA liquidation. 2009 WL

[10] http://www.sipc.org/media/release26feb03.cfm; emphasis added.

2185491, at *6. Yet, with the SEC's support, the *Byers* Court approved a formula wherein each investor's claim would be fixed at his investment plus any re-invested earnings. *Id*. at *4. Pursuant to this formula, an investor's claim would include any distribution that the investor chose to "roll over" into his account, even though such "distribution" never existed and did not correlate to an out of pocket loss. *Id.*

The *Byers* formula is equivalent to an investor's tax basis. In the Madoff case, an investor's tax basis would be the amount shown on his December 31, 2007 Madoff statement, adjusted for any investments or withdrawals that took place in 2008. Indeed, the Internal Revenue Service has recognized Madoff customers' claims as the amount of their tax basis. See Rev. Proc. 2009-20. The *Byers* formula is also similar to the method required under SIPA of fixing a claim in the amount of the investors' last statement, since the Customers' November 30, 2008 statement would reflect investments and withdrawals since the December 31, 2007 statement.

For some reason, the SEC advocated that result in a non-SIPA liquidation but it has refused to require SIPC to comply with the law in this case where, admittedly, the SEC bears 100% responsibility for the investors' losses.

The effect of SIPC's failure to comply with the statute has been absolutely devastating to my clients. If SIPC had promptly replaced securities in their accounts, they would have benefited from the remarkable appreciation in the stock market in the past seven months. Moreover, they would not have been forced to sell their homes in a depressed market, realizing a small percentage of the market value of their homes just a few years earlier.

Unfortunately, this case has become a classic struggle between Wall Street, represented by SIPC, and Main Street, represented by the destitute investors. And most unfortunately of all, in this battle the SEC has protected the interests of Wall Street over the innocent investors in Madoff.

Congress granted the SEC plenary jurisdiction over SIPC. SIPA imposes upon the SEC the obligation to enforce SIPA when SIPC violates the statute. Yet, the SEC has done nothing to require SIPC to fulfill its statutory obligations to investors and, instead, has sat by and watched the victims of the SEC's incompetence be devastated by SIPC's violation of its statutory obligations.

The SEC's conduct is particularly incomprehensible in view of the fact that SIPC could simply have utilized a portion of its $2 billion lines of credit to satisfy in full its obligations. SIPC needed only approximately $1.5 billion in addition to its own assets to fulfill this obligation. This is a mere 1% of the projected Wall Street bonuses in the year that the financial services industry brought the global economy to its knees. That 1% would hardly be noticed by Wall Street. But the entire world is watching as Wall Street cheats innocent investors of their promised insurance and the SEC is standing by, allowing it to happen.

Like all investors who deal with SEC-regulated broker/dealers, the Madoff investors understood that they had SIPC insurance. Indeed, every trade confirmation they received from Madoff indicated that Madoff's customers were insured by SIPC. Both SIPC's own writings, and the representations of brokers even to this day, assured customers that their accounts were insured up to $500,000, even where the broker was dishonest and never purchased the securities reflected on the customer's statements.

How can any American have confidence in the capital markets when the SEC won't even fulfill its statutory obligation to compel SIPC to comply with the law?

Tsunami 2: The clawback

I told you there were three tsunamis: the first was the loss of the Madoff investment. The second was the denial of SIPC insurance. But the third is the most devastating of all and it is truly a wonder that many of my clients are able to function at all under the stress caused by this last tsunami.

Let me take a minute to explain how Picard is using his new definition of "net equity" so that you can understand the clawback issue. Because of Madoff's unique place in the investment community over a period of almost 50 years, many of my clients are third generation Madoff investors. Let's just take one hypothetical example which is illustrative of the situation faced by many of my clients:

Assume that my grandfather – and again, this is just a hypothetical -- put $500,000 into Madoff in 1970. The account appreciated in value, as would any investment in the stock market. My grandfather died in 2003, at which time the account had a balance of $3 million. At that point, $1.5 million was taken out of the account to pay estate taxes. I then inherited the account, with a balance of $1.5 million which grew, by 2008, to 2.5 million. According to Picard, I would not be entitled to SIPC insurance because only $500,000 was invested in the account (the original investment by my grandfather in 1970) and $1.5 million was withdrawn from the account (to pay the estate taxes for my grandfather's estate and my mother's estate). Therefore, Picard would say, there was no net investment and no entitlement to SIPC insurance.

But it is much worse than that. Picard is demanding that people like me, in the above hypothetical, pay back to the bankruptcy estate all funds withdrawn within the past six years up to the amount of the negative net investment. So, in the hypothetical I have given you, my grandfather invested $500,000; $1.5 million was taken out to pay estate taxes; therefore the negative net investment in the account is $1 million. Picard is demanding that all that money be paid back.

Picard has been sending out letters to people in their 70's, 80's and 90's, who have already lost everything but their houses and their tax refunds, and he is demanding that they pay him back. In fact, Picard has already sued several elderly, virtually destitute investors who are fighting to hold onto the proceeds of the houses they were forced to sell after December 11, 2008 and the tax refunds they received from the Internal Revenue Service in 2009. These are the only funds they have left to cover all of their expenses for the rest of their lives. And now Picard is demanding that they turn over all of these funds to him.[11]

And for what purpose? Who would want to benefit from the recovery of these funds? This is blood money. I must tell you that I personally would benefit financially from the recovery of clawbacks but I am adamantly opposed to them. I never took any

[11] Although Picard is demanding payment of all withdrawals within six years of December 11, 2008, to the extent of each investor's negative net investment, there is substantial question as to whether Picard would have a right, under bankruptcy law, to claw back six years since 11 U.S.C. Section 546(e) limits a trustee to a two year statute of limitations when seeking to void a transfer by a broker in connection with a securities contract. This section provides as follows:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title**, the trustee may not avoid a transfer . . . that is a transfer made by . . . a stockbroker [or] financial institution, . . . in connection with a securities contract,** as defined in section 741(7) . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title. (Emphasis added.)

Section 741(7) defines a securities contract to be all-encompassing and it certainly covers the transactions here.

money out of my Madoff account and, if Picard recovered billions of dollars in clawbacks it would increase my distribution from the bankruptcy estate. However, I am opposed to clawbacks against innocent investors because I understand and support the Congressional intent to instill confidence in the capital markets by honoring the legitimate expectations of customers as reflected on their account statements. I represent many investors who are not subject to clawback who, similarly, are opposed to what Picard is doing.

Clearly, if a customer is entitled to rely upon the brokerage statements he receives from an SEC-regulated broker/dealer, then he cannot be required to disgorge funds he withdrew from his account.

It is one thing for investors to have been victimized by a criminal like Madoff. However, it is entirely another thing for investors to be victimized by SIPC and by the SEC's failure to enforce the law against SIPC. This is something that Congress cannot permit to continue. While I am confident that the Second Circuit will enforce the law against SIPC, it could take three years for the Second Circuit to rule and, in the meantime, the lives of thousands of innocent people are being destroyed, along with global investor confidence in our capital markets.

It is for this reason that I have proposed a clarifying amendment of SIPA to reinforce Congress' original intent to respect the legitimate expectations of customers who relied upon the trade confirmations and monthly account statements they received from their SEC-regulated brokers. No investor who had a legitimate expectation that his statements were accurate should be subject to a clawback suit, either a preference claim or a fraudulent conveyance claim. That still leaves plenty of room to sue the

Jeffry Picowers of the world because they could not have had a legitimate expectation that their statements were accurate.

The Need to Put Some Teeth in "Promptly"

There is one last issue that I would like to address. And that is the SIPA mandate that SIPC "promptly" replace securities in a customer's account. Congress made absolutely clear its intention to minimize the devastation to customers of an insolvent broker/dealer through prompt payment of SIPC insurance.

> GENERAL PROVISIONS OF A LIQUIDATION PROCEEDING
>
> **(a) PURPOSES**
>
> The purposes of a liquidation proceeding under this chapter shall be—
>
> (1) **as promptly as possible** after the appointment of a trustee in such liquidation proceeding, and in accordance with the provisions of this chapter—
>
> (A) to deliver customer name securities to or on behalf of the customers of the debtor entitled thereto as provided in §78fff-2(c)(2) of this title; and
>
> (B) to distribute customer property and (in advance thereof or concurrently therewith) otherwise satisfy net equity claims of customers to the extent provided in this section.
>
> **PAYMENT TO CUSTOMERS.-SIPC shall promptly satisfy all obligations of the member to each of its customers relating to, or net equity claims** based upon, securities or cash by the delivery of securities or the effecting of payments to such customer (subject to the provisions of section8 (d) and section **9** (a)) insofar as such obligations are ascertainable from the books and records of the member or are otherwise established to the satisfaction of SIPC.

15 U.S.C. §78fff-2(c)(2); emphasis added. *See also,* 15 U.S.C. § 78fff-3(a).

Congress intended for the trustee to promptly pay customer claims based upon the debtor's books and records, without the filing of proofs of claim:

> **[SIPA] establishes procedures** for prompt orderly liquidation of SIPC members when required and **for making prompt distributions and payments on account of customers' claims without need for formal proofs of claim.**
>
> * * *
>
> The committee also believes that **it is in the interest of customers of a debtor that securities held for their account be distributed to them as rapidly as possible in order to minimize the period during which they are unable to trade and consequently are at the risk of market fluctuations.**
>
> * * *
>
> **Because of the difficulties involved in filing proofs of claim . . ., the bill provides in general for the trustee to make payments and deliveries based upon the books and records of the debtor or when otherwise established to his satisfaction, without requiring customers to file proofs of claim.**[12]

While SIPC has never asserted that it could replace investors' securities within 48 hours, it has set a standard of doing so within two to three months. In *SIPC v. SJ Salmon & Co.*, No. 72 Civ. 560 (S.D.N.Y. 1972), 1500 out of 2000 claims had been

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[12] (S. Rep. 91-1218, at 10, 11, 12 (1970), *reprinted in* Federal Securities Laws Legislative History 1933-1982, Vol. IV, at 4642, 4643, 4644 (1983)). Thus, as the Sixth Circuit explained in *Bell & Beckwith v. McGraw*, 937 F. 2d 1104, 1106-1107 (6th Cir. 1991)*:*

> Implementing this statutory scheme is complicated by the congressional requirement that SIPC make prompt payments to customers. These payments take the form of advances which are used to satisfy customer claims:
>
> > SIPC would advance to the trustee such sums from the SIPC fund as would be necessary to provide for prompt payment of claims of customers of the debtor, but only to the extent of [$500,000] for each customer. This significant provision will make it possible for public customers to receive promptly that to which they are entitled without the delay entailed in waiting for the liquidation proceeding to be completed. In addition, and subject to the limitation of [$500,000, of which not more than $100,000 may be in satisfaction of a claim based on cash], public customers of the broker-dealer would receive back 100 percent of that to which they are entitled.
>
> House Report at 5262; 15 U.S.C. Sec. 78fff-3. SIPC makes such advances prior to a determination of each customer's ratable share of or distribution from the customer property fund.

paid within a few months. [13] As recently as November 2007, Harbeck stated:

> The fastest that an investor could conceivably get back in control of one's account is one week" but he added that "In most situations, it takes two to three months." The article further stated that "the process can stretch out even longer if the brokerage firm kept shoddy records.[14]

In the Madoff case, there is no evidence that the records were shoddy. On the contrary, Picard has been able to precisely reconstruct investors' net investment going back into the 1980's. Yet, Picard paid virtually no claims for the first five months of the case. Even after 12 months, he has paid only approximately 2/3 of the claims that he has considered valid, using his improper definition of "net equity." One must recognize, here, that Picard and his law firm are being compensated at the rate of approximately $1 million per week. It is certainly to their advantage to keep this stream of income flowing for five to ten years. However, nothing could be more destructive to the national crisis in confidence on our capital markets.

One must also recognize that SIPC's history, unfortunately, has been to delay

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[13] The court wrote:

> This action was instituted early this year and the trustee is proceeding with all due speed in his investigation and orderly liquidation of the business of the defendant. Approximately 2,000 claims have been filed; securities and cash have been returned to some 1,500 customers as either specifically identifiable property or as payment of the portion of "net equities" in the single and separate fund representing free credit balances. This clearly indicates that the trustee is proceeding as swiftly as the circumstances of the case permit and negates any suggestion that he is guilty of unnecessary delay or dilatory tactics in the performance of his duties.

[14] www.kiplinger.com/printstory.php?pid=12842

and try to defeat customer claims.[15] While the statute mandates prompt payment, it

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[15] Members of Congress repeatedly complained that SIPC was acting adversely to the interests of the customers it was charged with protecting. The GAO Report issued in 2001 found that there were "significant deficiencies" in SIPC, and Rep. Dingell told the New York Times that "SIPC's mission is to promote confidence in securities markets by facilitating the prompt return of missing customer cash and/or securities held at a failed firm. However, the large number of claims denied in several recent high-profile SIPC liquidation proceedings has raised concern that SIPC policies may unduly limit the actual protection afforded consumers."

Representative Kanjorski was also quoted in the New York Times article as stating that:

> According to the GAO, both the SIPC and the SEC have fallen short in their duty to make sure that investors are informed on the actions they need to take to protect their interests. Both Congress and the administration must address these concerns and deficiencies promptly, especially as more Americans than ever – roughly 50 percent – are invested in the stock market.

Id..

Representative Dingell was so agitated by SIPC's policies that he sent a letter to the Acting Chairmen of the SEC and SIPC on June 20, 2001 regarding SIPC's deficiencies in the wake of the GAO report, and posted the letter to the Committee on Energy and Commerce's website. Rep. Dingell wrote that:

> the large number of claims denied in several recent high-profile SIPC liquidation proceedings have raised concerns that SIPC policies and practices may unduly limit the actual protection afforded customers. Critics argue that SIPC's main goal has been to protect its industry-supplied fund rather than to protect customers as contemplated by SIPC.[15]

Two years later, the July 2003 United States Accounting Office Report also caused consternation in Congress. In their August 11, 2003 letter, Reps. Frank, Kanjorski and Dingell declared that they were "deeply troubled by the state of affairs" at SIPC outlined in the GAO Report.[15] The letter stated that the Congressmen "cannot overstate the importance of the SIPC program in the ongoing effort to restore and maintain investor confidence" and criticized SIPC's failure to cure the deficiencies outlined in the GAO Report.[15]

Reps. Frank, Kanjorski and Dingell stated that this situation was "totally unacceptable and [they] urge[d] SIPC to fix these shortcomings, which [they] consider[ed] to be significant, with all deliberate speed before a major problem occurs."

The Congressmen "strongly agree[d]" with the statement in the GAO Report that:

> Disclosure has an important role in securities market regulation, and the Securities Investor Protection Corporation (SIPC) has a responsibility to inform investors of actions they can take to protect their investments and help ensure that investors are afforded the full protections allowable under the Securities Investor Protection Act of 1970 (SIPA).

Id.

does not provide for interest if SIPC delays inordinately in paying claims. The statute should require SIPC, if it delays in paying customer claims, to give the customer the choice of either having $500,000 of securities replaced in his account, valued as of the date of the liquidation, or paying $500,000 with a rate of interest, such as 7%, which has some real teeth to it. The last 39 years have taught us that, without this protection, SIPC will continue to victimize investors.[16]

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[16] Despite Congressional warnings, SIPC has appointed mere "puppets" to act as trustees in SIPA proceedings. *In re First State Securities Corp.*, 39 B.R. 26 (B.S.D. Fla. 1984). These puppets have advanced frivolous arguments to delay and defeat customer claims. For example, Irving Picard, as SIPC Trustee, was chastised by one court for advancing a totally frivolous argument in his attempt to defeat a valid customer claim, after he had tried to threaten and intimidate the customer. In *In re Investors Center, Inc.*, 129 B.R. 339 (B.E.D.N.Y. 1991), Picard was faced with customer claims for cash where the customers had received confirmations from the broker that their securities had been sold. After the sale, the securities became worthless and SIPC wanted to simply replace the worthless securities rather than pay the cash that was reflected on the account statements. The court held that "Under [SIPC's] rules, each of the objecting *claimants*, because of the receipt of written confirmation of a sale prior to the filing of SIPC's application to liquidate Investors Center, has a claim for cash and not for securities and the Trustee's determination otherwise is incorrect." The court wrote:

> Except that the Trustee appears to urge this most seriously, the Court would deem the contention too frivolous to even consider.

In rejecting Picard's argument, the court cited 17 C.F.R. 501(a)(1), (2) and stated "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 348. Despite this inauspicious conduct, SIPC chose Picard as the trustee in the Madoff case.

See also, In *In re Investors Security Corp*., 6 B.R. 415 (B. W.D.Pa. 1980), SIPC and the trustee argued that two accounts, one held by an investor individually and one held jointly by the investor and his wife, should be treated as belonging to one "customer," thus making the investor and his wife entitled only to the statutory minimum, rather than twice the statutory minimum. The court found that the two accounts were held by two separate customers, and ordered a judgment against the trustee in the statutory minimum at that time. However, SIPC had successfully delayed for nearly five years from the date the claims were filed.

In a later proceeding in the same case, *In re Investors Security Corp*., 30 B.R. 214 (B. W.D.Pa. 1983), SIPC and the trustee filed a motion for reconsideration and to alter judgments after the court entered a judgment finding that two investors were "customers" within the meaning of SIPC. After reviewing all of the "expanded record, counsel's motions and their brief in support thereof," the court remained "firmly convinced that the [investors] fall squarely within the definition of 'customer' as set forth in the SIPA statute, and are therefore entitled to its protection." However, SIPC obtained a delay of nearly eight months between the court's first decision in favor of the investors and its second decision, reiterating its findings in favor of the investors.

In *SIPC v. Ambassador Church Finance/Development Group, Inc*., 788 F.2d 1208 (6th Cir. 1986), SIPC litigated for over 7 1/2 years the question of whether investors were "customers" under SIPA, a question that the Sixth Circuit decided in favor of the investors.

In this case, SIPC has delayed payment to customers while the stock market has increased approximately 40%. SIPC claims that it was impractical to replace securities, as required by the statute. However, even if it would have been impractical to replace the securities in the 4,904 accounts within 60 days, it certainly would not have been impractical to do so over a 12-month period. In fact, even after eliminating more than half of the customer claims, Picard has still not paid 1/3 of the account holders to whom he acknowledges he owes money. And this is a 12-month period in which Picard and his law firm have earned fees of $1 million per week.

The $52 million that Picard will be paid for his first year could have satisfied SIPC's obligation to 104 Madoff victims.

I thank you very much, on behalf of my clients, for giving me this opportunity to address you.

Helen Davis Chaitman

In *In re C.J. Wright & Co., Inc.*, 162 B.R. 597 (B. M.D. Fla. 1993), claimants objected to the trustee's determination that they were not customers. The claimants had deposited money with the debtor in the belief that the debtor was purchasing CD's with such funds. The trustee argued that the funds were loans because CD's were never purchased with the funds. The court found that the claimants did not intend to loan funds to the debtor, but entrusted the monies with the debtor for the purposes of purchasing securities (the CD's). Thus, the court ruled claimants were customers within the meaning of SIPA and had claims for cash. Yet, through litigation, SIPC delayed paying such customers for over one year. Harbeck acted as counsel for SIPC in the matter.

In *In re Primeline Securities Corp*, 295 F.3d 1100 (10th Cir. 2002), SIPC delayed payment of customer claims for four years. The bankruptcy court had ruled that claimants (and others) were entitled to payments, but the trustee and SIPC had filed an appeal. The district court found that the claimants were not entitled to payments and were not "customers." The Court of Appeals reversed and remanded the district court order denying customer status to claimants with respect to funds each claimant sought to invest in debentures. The protective order was entered in 1998, but the 10th Circuit decision was not entered until 2002. Harbeck was on the brief for SIPC and the trustee.