No. 23-1175

In the Supreme Court of the United States

MALCOLM H. SAGE,

Petitioner,

v.

IRVING H. PICARD, ET AL.,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does an Article III Court have the power to reject the statutory definition of "net equity" as set forth in 15 U.S.C. Section 78aaa *et seq.* by employing the Madoff Trustee's "Net Investment Method" ("NIM") as a formula to calculate the net equity of a customer in contradiction of the plain text of SIPA?

2. If the Courts below have such power, did the District Court and the Court of Appeals nevertheless err in upholding the use of the Net Investment Method advocated by a SIPC Trustee to disallow Petitioner's "net equity" claim and clawback funds under circumstances where Petitioner maintained a traditional buy and hold stock brokerage account, did not relinquish control of his accounts to Madoff, but, instead, directed trading in specific securities in his account?

PARTIES TO THE PROCEEDINGS

Petitioner and Defendant-Appellant below

- Malcolm H. Sage, in his Capacity as Partner or Joint Venturer of Sage Associates and Sage Realty, Individually as Beneficiary of Sage Associates and Sage Realty, and as the Personal Representative of The Estate of Lillian M. Sage.

  Note: Sage Associates and Sage Realty, of which Petitioner was a principal are defunct.

Respondent and Plaintiff-Appellee below

- Irving H. Picard, the Trustee for the liquidation of Bernard L. Madoff Investment Securities LLC

Party in Interest and Intervenor in the Second Circuit

- Securities Investor Protection Corporation (a party in interest in all liquidation proceedings commenced under the Securities Investor Protection Act, 15 U.S.C. § 78eee(d))

LIST OF PROCEEDINGS

Direct Proceedings Below

In re Bernard L. Madoff Investment Securities LLC, Nos. 22-1107(L), 22-1110-bk(CON), U.S. Court of Appeals for the Second Circuit. Summary Order August 10, 2023; Rehearing Denied November 28, 2023.

Picard v. Sage Associates et.al., No. 1:20-cv-10057, U.S. District Court for the for the Southern District of New York. Judgment entered April 20, 2021.

Picard v. Sage Realty et.al., No. 1:20-cv-10109, U.S. District Court for the for the Southern District of New York. Judgment entered April 20, 2021.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner MALCOLM H. SAGE respectfully petitions this Court for a writ of certiorari to review the order of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The Opinion of the Court of Appeals for the Second Circuit (the "Second Circuit"), in Nos. 22-1107(L) and 22-1110-bk (CON), *In re Bernard L. Madoff Inv. Sec. LLC* (2d Cir. 2023) (the "Panel") is included at App.1a. The opinion of the District Court for the Southern District of New York, No. 20 Civ. 10109 (JFK) & No. 20 Civ. 10057 (JFK) ("District Court") in *Picard v. Sage Realty et.al.*, 2002 WL 1125643 (S.D.N.Y. 2022) is included at App.14a. The opinion of the District Court removing matters from the Bankruptcy Court in *Picard v. Sage Realty et.al.*, 20-cv-10109 (AJN) (S.D.N.Y. May 18, 2021) is included at App.96a.

JURISDICTION

This Court has jurisdiction under 28 U.S.C. § 1254(1).

The Second Circuit entered its judgment on August 10, 2023 (App.1a) and the Panel denied rehearing on November 28, 2023 (App.114a). The Court granted an

extension to file a petition for a writ of certiorari through April 26, 2024. Sup. Ct. No. 23A765 (App.153a).

The final order of the Panel affirmed a final order of the District Court (App.14a) which, *inter alia*, held that Petitioner's net equity was determined by the "NIM" (deposits less withdrawals) over the life of the accounts—going back approximately 30 years before the bankruptcy.

STATUTORY PROVISIONS INVOLVED

Relevant portions of the Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. §§ 78aaa *et seq.*, are reproduced in the App.144a-152a.

STATEMENT OF THE CASE

A. Factual Background

The Sage Associates ("SA") and Sage Realty ("SR") matters arose out of the Madoff debacle. In the aftermath of the worst financial scandal in the history of Wall Street, both cases were swept up in the maelstrom of litigation which ensued. The cases were tried together because of the common thread of the perpetrator of the crime, but in fact, the cases were entirely different.

SA and SR have been defunct since the Madoff bankruptcy. SA consisted of three siblings Malcolm, Martin & Ann Sage. SR included the three siblings and four close family members. Neither SR nor SA operated as a business, nor did they incur business

profits or losses as shown on the tax returns produced to the Trustee. 100% of the income was investment income consisting solely of capital losses or gains, interest, and dividends.

SR maintained a split-strike account (*infra* at 20-25) with Madoff. Split-strike accounts involved a bogus strategy invented by Madoff. With the single exception of SA's case, every other Madoff clawback case against concededly innocent victims, litigated over the past 15 years, involved a split-strike account where the customer gave Madoff total control over purchases and sales of securities in their account.

SA was not a split-strike account but a typical buy and hold account (*infra* at 20-25) where customers invest in capital markets by selecting, purchasing, holding, and selling specific stocks. Buy and hold focuses primarily on long-term potential rather than short-term market fluctuations as split-strike did. The mechanics of split-strike were entirely different from buy and hold. Split-strike, as that term has been used in the Madoff cases "supposedly involved Madoff, solely at his discretion, buying a basket of stocks listed on the Standard & Poor's 100 Index and hedging through the use of options," (App.118a) on a strictly short-term trading basis.

While SA was *sui generis* in the litigation in the Madoff world, SA was in the class of hundreds of millions of investors in the real world who invest in capital markets. In fact, the SEC claims that it "over-see[s] more than $100 trillion in securities trading on U.S. equity markets annually."[1] SA was fully typical of the average investor who buys and holds a stock

[1] U.S. Securities and Exchange Commission Mission Statement https://www.sec.gov/about/mission

portfolio to build a nest egg for their medical, educational, family, personal, and retirement needs.

B. A Case of First Impression and Unsettled Law

On May 18, 2021, Judge Alison Nathan,[2] removed the Sage cases from the Bankruptcy Court, opining that she was legally mandated to do so because the "case squarely involves a matter of first impression, undecided by the Second Circuit," (App.113a) and that it required "significant interpretation and application of non-bankruptcy federal law." (App.113a) Judge Nathan observed that the case involved several questions of "unsettled" law (App.107a, 108a, 109a, 113a), as well as a question of "statutory interpretation." (App.106a)

Judge Nathan noted: "One of the primary issues presented in the adversary proceeding is whether the Net Investment Method ("NIM") can be applied to the Defendants' customer accounts." (App.106a)

The NIM formula was invented by the SIPA Trustee and recognized by the Second Circuit to disallow claims of Madoff customers whose funds were invested in Madoff's split-strike scheme. (*In re Bernard L. Madoff Inv. Securities LLC*, 654 F.3d 229 (2011)). There is no authority under SIPA, or its legislative history, to justify the NIM, under which a customer's net equity is credited with the amount of cash deposited by the customer into their account from the date the

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[2] SDNY Judge Nathan was assigned to decide whether a removal of the reference motion was mandated in the Sage matters in November 2020. She left the case one year later and on the very day when direct testimony was placed on the District Court docket. She was replaced by Judge John Keenan, (SJ, S.D.N.Y.) who took over the case on 11/01/2021. Judge Nathan currently serves on the Court of Appeals for the Second Circuit.

account was opened, less all amounts withdrawn from it over the lifetime of the account. But that legal error is grossly compounded in this case because the NIM has been applied to the SA account where investment decisions were not ceded to Madoff but maintained by the customer.

Judge Nathan recognized the fundamental issue laid out by the Circuit of where "a customer's account statement is an accurate or reliable representation of their 'securities positions'" (App.108a) noting that the Circuit was concerned about whether it was "permissible" to employ the NIM under § 78lll(11) SIPA to "calculate sums owed" because doing so would "wipe[] out all events of a customer's investment history except for cash deposits and withdrawals." (App.108a)

Judge Nathan wrote: "without delving into the merits prematurely, the Court notes that, contrary to the Trustee's contention, it may be the case that the most appropriate method for calculating the Defendants' net equity under SIPA is the Last Statement Balance method." ("LSM") (App.107a)

The LSM is dictated by SIPA and assures customers that they can rely on the statements they receive from their brokers to determine net equity and requires SIPC to pay customers claims from the customer protection fund based upon the amount the broker owes them, as reflected on their last statement. *See* 15 U.S.C. § 78lll(11).

Still further, in her Opinion, written ten-years after the Second Circuit defined net equity by resorting to the NIM for split-strike customers (App.116a, 131a fn7), Judge Nathan explained: "The question in this adversary proceeding is not merely which method is

most appropriate to determine the Defendants' net equity, but whether the Net Investment Method, the method that the Trustee has already chosen, is a *permissible* method as a matter of law under SIPA." (App.108a) (emphasis in original)

Finally, Judge Nathan noted that:

1) "neither § 78fff-1, which covers the 'Powers and duties of a trustee' under SIPA, nor § 78lll(11), which defines net equity, discuss whether the Trustee has discretion for choosing how to calculate net equity, and if so, to what degree." (App.110a), and

2) "Therefore, determining if the Trustee is permitted to use the Net Investment Method for calculating the Defendants' net equity may very well require the court to hold as a matter of law for the first time the scope of a Trustee's power to choose a method for calculating net equity under SIPA." (App.110a)

Indeed, Judge Nathan's conclusion is bolstered by the Second Circuit's observation that Courts have been exceedingly reluctant to accord either *Chevron* deference or even the more limited *Skidmore* deference to SIPC itself, much less to a SIPA-selected, court-appointed trustee. (*In re New Times Securities Services, Inc.* 371 F.3d 68, p.76-83. (2004); *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 104 S.Ct. 2778 (1984); and *Skidmore v. Swift & Co.*, 323 U.S. 134, 65 S.Ct. 161 (1944)).

In *New Times*, SIPC argued that other government-created corporations have been accorded "Chevron-style deference" (*New Times* at 78) but the Court in *New Times* cited key differences in several cases leading

it to conclude that: 1) SIPC did not have authority similar to those corporations, (*New Times* at 78), 2) SIPC, as a non "governmental agency" could not "take advantage of . . . implicit deference" (*Id.*), 3) "Congress deliberately limited the authority of SIPC relative to the SEC," which was given "plenary authority to supervise SIPC," even to the extent that the SEC could "require SIPC to adopt, amend or repeal any SIPC bylaw or rule, whenever adopted," (*Id.* at 77), and 4) "[w]hatever SIPC's expertise in overseeing SIPA liquidations, Congress did not intend for the Commission's interpretations of SIPA to be overruled by deference to the entity that was made subject to the Commission's oversight." (*id.*at 80) *see* 15 U.S.C. § 78ccc(e)(3) & § 78ggg(c) (1970)

In *Securities Investor Protection Corp. v. 2427 Parent Corp*, 779 F.3d 74 (2d Cir. 2015), the 2d Circuit, in a Madoff split-strike case, refused to accord *Skidmore* deference to even the SEC under circumstances where the agency sought an adjustment for inflation for Madoff customers absent a provision for interest adjustment under SIPA. In *Parent Corp.*, the Circuit ruled that "SIPA's text does not provide for an inflation adjustment to net equity." (*Id.* at 79) In so holding, the Circuit's adherence to plain text was manifest and deference to read beyond the plain text of SIPA was prohibited.

Neither the District Court nor the Panel questioned the right of a Trustee to choose a method to calculate net equity. Further, neither considered whether the facts of the SA buy and hold account merited a different method (*i.e.* either the LSM or another method entirely as the Net Equity Decision held: "The two competing methods of calculating 'net equity' proposed by the parties to this litigation are the only two methods at

issue here. We do not hold that they are the only possible approaches to calculation of 'net equity' under SIPA") (App.125a-fn5).

If a Trustee is afforded deference to define net equity by selecting a method of calculating it outside both the plain meaning of the statute and the narrow (legally questionable) exception the Circuit made for schemes like split-strike, a SIPC Trustee will always impose the NIM because it minimizes the burden on the SIPC's members to fund the SIPC customer fund.[3] Ultimately, the cost of the failure would fall, not on SIPC's members as Congress expressly intended, but rather on the very customers whose investments were intended to be protected.

Judge Nathan's question as to whether the NIM is even "a permissible method as a matter of law under SIPA" (App.108a) is reflective of a split in opinion within the Circuit, as to the employment of the NIM in the first place, or under disparate factual circumstances than the split-strike customers in the Net Equity Decision.

In extending the use of the NIM to the buy and hold SA account, the District Court misapprehended Judge Nathan's Opinion by entirely overlooking her observation that the Second Circuit in the Net Equity Decision applied the principles of its interpretation of SIPA solely to "the BLMIS customers involved in that appeal, which were the ones for whom Madoff claimed

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[3] At the time of the Madoff debacle, every brokerage firm in America, from Goldman Sachs to Charles Schwab paid a mere $150 premium towards the fund annually. Unimaginably, this fee covered an entire firm's responsibility regardless of the number of customers or the level of business engaged.

to have implemented the 'split-strike conversion' investment strategy." (App.103a).

The Panel herein inexplicably overlooked Judge Nathan's Opinion, and the questions she raised. In fact, the Panel never even referenced her opinion in its order affirming the judgment of the District Court.

It was error for the courts below to overlook the question of what it would mean for the NIM to be applied to a buy and hold account. The answer is clear: if a Trustee is permitted to claw back even under the circumstances of buy and hold, he would essentially be able to substitute SIPA's statutory framework with a "cash-in/cash-out" approach, based on subjective personal views of fairness and theories of avoidance that have no foundation in the law.

What would then emerge is either the very "one size fits all" (App.139a) formula that the Circuit admonished against, or *ad hoc* decisions and inconsistent methods to calculate net equity that would destroy investor confidence in the securities markets. Moreover, it would leave innocent customers of failed brokerage houses uncertain—not only as to whether they might collect monies from the SIPC customer protection fund —but also whether they themselves might be compelled to contribute to the customer protection fund, even in circumstances where the customer didn't relinquish full investment authority to a broker but instead directed trading of securities in the account and authorized or directed the purchase of specific stock in the account.

The Circuit in the Net Equity Decision stated: "Indeed, the Last Statement Method may be especially appropriate where—unlike with the BLMIS accounts at issue in this appeal—customers authorize or direct

purchases of specific stocks." (App.132a). In fact, the Panel recognized that Appellant: "effectively argued that the facts of his case satisfy Net Equity's dicta regarding the kind of case in which the Last Statement Method would be appropriate because he is a customer that authorized or directed Madoff's purchase of specific stocks." (App.6a-7a). Nevertheless, the Second Circuit upheld the use of the NIM in SA's buy and hold account.

By misquoting the Net Equity Decision and erroneously omitting critical words used by the Circuit therein, the Panel showed its misunderstanding of a vital aspect of the holding in that case. The Panel's misquote from the Net Equity Decision was: "The Last Statement Method may be appropriate when securities were actually purchased by the debtor, but then converted by the debtor or where . . . customers authorize or direct purchases of specific stocks." (App.6a) (Emphasis added)

What the Net Equity Decision actually said was quite different: "Indeed, the Last Statement Method may be especially appropriate where—unlike with the BLMIS accounts at issue in this appeal—customers authorize or direct purchases of specific stocks." (App. 132a-133a) (Emphasis added) That language makes clear that the Circuit would have ruled that Appellant was entitled to have its claim allowed based upon the last statement it received from Madoff.

As the Second Circuit is overwhelmingly the most likely venue to encounter litigation under SIPA because it is where the securities firms are located, it is very unlikely that a full split between Circuits might ever arise. That makes the intra-circuit split arising out of Judge Nathan's 2021 opinion enormously significant.

Coupled with the massive number of customers who trade more than a hundred trillion dollars in equity markets annually,[4] which makes the question presented in this matter one of national importance, the Court should grant this Petition for Certiorari.

C. Statutory Background

In 1970, Congress, enacted SIPA in response to the collapse of numerous brokerage houses at the end of the 1960's. Congress divided the responsibilities for implementing SIPA between the SEC and a newly established body, the SECURITIES INVESTOR PROTECTION CORPORATION ("SIPC"), a nonprofit corporation controlled by the securities industry. SIPC is not "an agency or establishment of the United States Government . . . and Congress 'deliberately limited' its authority 'relative to the SEC.'" (*New Times* at 76).

SIPA was enacted to deal with an evolving marketplace where equities were no longer tangibly possessed by the customers. Instead, from then on, the only evidence the customer had of the securities he had purchased, and his holdings, were trade confirmations and monthly account statements sent by their licensed broker.

SIPA is a remedial statute enacted to promote the legitimate expectations of a customer, instill investor confidence, forestall the failure of brokerage firms, and provide protection for customers whose assets were lost resulting from the failures. (*Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412, 414 (1975)).

Nowhere in the record was it even contemplated that if a licensed broker committed fraud, a SIPA

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[4] https://www.sec.gov/about/mission

Trustee could turn up 30-years later and say that all the monies an individual withdrew exceeding what he deposited in those three decades needed to be turned over to SIPC.

D. The 2011 Net Equity Decision established the use of the NIM to calculate Net Equity, but its holding was narrowly confined and limited to Madoff's split-strike scheme

The Net Equity Decision permitting the use of the NIM in the narrowly confined circumstances of Madoff's split-strike scheme is inconsistent with the plain text of § 78lll(11) which indicates that customers' claims be allowed for the balance on their last statement.

The SIPA definition of the term net equity means:

"The dollar amount of the account or accounts of a customer, to be determined by—

(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—

(i) all securities positions of such customer (other than customer name securities reclaimed by such customer); and . . .

B) any indebtedness of such customer to the debtor on the filing date."

In the Net Equity case, instead of shielding all concededly innocent customers and good faith transferees from Madoff's brokerage failure, SIPC and its Trustee "advocated" (App.131a, fn.7) for the disallowance of all customer claims arising from investment in

the split-strike conversion strategy. The Trustee then sued all innocent customers of Madoff whose funds were invested in the split-strike strategy for alleged fraudulent transfers where these customers legally withdrew funds from their accounts over decades and paid short-term capital gains taxes on their investment returns.

In ignoring the text of SIPA, the Circuit approved SIPC's disallowance of the claims of all split-strike customers in determining each customer's net equity.

The Circuit recognized that the NIM was draconian because it "wipe(d) out all events of a customer's investment history except for cash deposits and withdrawals" (App.132a). Nevertheless, the Second Circuit determined that it could be employed to protect the split-strike net-losers. A net-loser according to the Trustee is an individual who withdrew less money than he put into his account over the lifetime of the account. SIPC President Stephen Harbeck conceded the *ad hoc* nature of the Trustee's approach to the NIM in this case when he stated shortly after the SIPC customer claim form was mailed out to thousands of Madoff customers on January 2, 2009: "We've modified our usual claim form to ask investors a question that's unique to this case, which is how much money did you put in and how much money did you take out."[5] Conversely, a net-winner according to the Trustee was an individual who withdrew monies exceeding his original investment and further deposits. In fact, the plain text of SIPA mentions neither net-winners

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[5] Jan. 6, 2009, *SIPC Chief Speaks Out*, January 6, 2009 CNBC https://www.youtube.com/watch?v=gyywi9zp0qc.

nor net-losers. Those terms were constructs established by the Trustee herein.

Critically, the Second Circuit confined its decision by establishing key criteria for the NIM to apply:

i) Its application was limited to the customers who "relinquished all investment authority" and invested in Madoff's scheme, his "split-strike conversion strategy." (App.117a)

ii) It held that the NIM was confined to the "extraordinary facts" and circumstances surrounding split-strike and the split-strike customers. (App.132a)

iii) It held that its decision would be inapplicable in "more conventional cases" where a "customer's last account statement will likely be the most appropriate means of calculating "net equity." (App.132a)

iv) It held that powerful reasons for its ultimate decision was that split-strike trades were "rigged to reflect a steady and upward trajectory in good times and bad." (App.131a)

However, given that the NIM formula might result in the financial ruination of innocent victims of a crime who had already been devastated, the Circuit in dealing with the gravity of the situation:

i) Noted that it expected that application of the Trustee's method for calculating net equity to cases involving failed brokerage houses would be "rare." (App.132a)

ii) Stated that "Indeed, the Last Statement Method may be especially appropriate where

—unlike with the BLMIS accounts at issue in this appeal—customers authorize or direct purchases of specific stocks." (App.132a-133a)

iii) Took the position that "Differing fact patterns will inevitably call for differing approaches to ascertaining the fairest method for approximating 'net equity,' as defined by SIPA." (App.125a)

iv) Concluded that "SIPA covers potentially a multitude of situations," (App.139a) and "the statutory language does not prescribe a single means of calculating 'net equity' that applies in the myriad circumstances that may arise in a SIPA liquidation," (App.125a). Further it concluded that "While SIPA does not—and cannot—protect an investor against all losses, it 'does . . . protect claimants who attempt to invest through their brokerage firm but are defrauded by dishonest brokers.'" (App.127a).

v) Drew a line in the sand stating that, as respected what formula might be employed to calculate net equity, "No one size fits all." (App.139a)

In essence, the Circuit in the Net Equity Decision set up an evaluative test listing multiple factors to consider in determining what formula might be the most appropriate to employ in calculating net equity absent a provision in SIPA to do so.

Ultimately, the Net Equity Decision held the NIM, in the context only of Madoff's split-strike investment strategy, to be "superior to the Last Statement Method as a matter of law" (App.131a, fn7). Critically, the Circuit's decision was painstakingly constrained solely

to the calculation of net equity for the 95% of individuals who invested in Madoff's split-strike scheme in view of the factors it weighed. The Court expressly stated that the NIM would not be appropriate for an account, like the one at issue here, where the customer, not Madoff, made investment decisions over the life of the account.

The SEC and SIPC have for decades participated in Congressional hearings relating to SIPA. At a 2012 House of Representatives hearing[6] in the aftermath of the Madoff disaster and following the Second Circuit's 2011 net equity decision, concerns were raised about allowing SIPC and not the SEC (*House Hearing* at 5, 18) to select a Trustee because of fears that a non-"neutral" (*Id.* at 18) Trustee would administer the fund more favorably to its client by seeking the imposition of the NIM to protect SIPC at the expense of innocent customers who one congressman described as having been victimized by an improperly supervised Trustee through the use of "an accounting mechanism that disregards real-world customer expectations and broker-dealer protocol," (*Id.* at 7) and which could happen to "any investor whose broker fails for any reason." (*Id.* at 8). Legislation was proposed but not enacted and nothing has changed in the ensuing decade despite SIPC's establishment of a "Modernization Task Force." (*Id* at 9). Nothing will change so long as a Trustee can advocate for the NIM and persuade a court to impose it even on buy and hold brokerage account holders. Ironically, this methodology requires one non-statutory

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[6] House Hearing, 112 Congress, Second Session, U.S. Government Pub. *SIPC-Past, Present, And Future*, Hearing-Subcommittee on Capital Markets and Government Sponsored Enterprise of the Committee on Financial Services, March 7, 2012.

class of brokerage house customers (net-winners), to reimburse another non-statutory class of brokerage house customers (net-losers), thereby relieving securities firms of the financial obligations imposed upon them under SIPA, even where the plain statutory text expressly mandates the Last Statement Method. The Circuit made its concern about the vagueness of the SIPA statute known by citing the following from *McKenny v. McGraw (In re Bell & Beckwith)*, 104 B.R. 842, at 848 (Bankr. N.D. Ohio): "The intent of Congress to protect customers of financially distressed security dealers is clear, but the specifics of precise resolution of individual situations are clouded by the provisions of a statute which range far from the clarity of blue sky one might expect in this area of the law." (A7 at 235). In fact, Judge Lifland, whose opinion to employ the NIM for split-strike investors was upheld in the Net Equity Decision, pointed to the same lack of clarity when he stated in 2010 that the "application of the Net Equity definition" to Madoff's scheme was not "plainly ascertainable in law." (*In re Bernard L. Madoff Inv. Securities LLC*, 424 B.R. 122 at 125 (2010))

Buy and hold investors have the need and the right to know what will happen to their brokerage accounts where their brokerage house fails. Unfortunately, because of SIPC's fecklessness and the increasing dishonest conduct among employees of brokerage firms, Congress' mission, through SIPA, to instill confidence in the securities industry has been totally frustrated.

This case presents an opportunity for this Court to send an important message to the Second Circuit: the plain language of a federal statute must be honored, particularly where the statute is intended to provide

consumer protection. Under the plain language of SIPA, neither the Trustee nor the Second Circuit had the power to disallow customer claims based on their last statements. Nor did the Trustee or the Second Circuit have the power to disallow a claim of a customer like SA who had a buy and hold account, did not relinquish full investment authority to the broker but authorized or directed the trading of specific stock in their account.

E. The Panel erred in affirming the District Court decision that the net equity in SA was properly determined by using the Net Investment Method

The Panel erred from the outset in framing the "central question" (App.5a) incorrectly. It stated: "The central question on appeal is whether the district court applied the correct calculation method for determining the amount of net equity in the Sage Accounts." (App.5a). In conflating Sage Associates with the "Sage Accounts," the central question was disregarded. In fact, the Panel missed two critical questions:

1. Should the NIM be applied to Sage Associates, a buy and hold account that was not the subject of the Net Equity Decision but as Judge Nathan stated: "this case squarely involves 'a matter of first impression, undecided by the Second Circuit.'" (App.113a)
2. Was it even permissible in the first place to ignore the plain language of SIPA and employ the NIM to calculate net equity? (App.108a)

In the Panel's holding that the calculation of net equity in SA using the NIM was "the most reasonable calculation method," (App.5a) the Panel reached the following erroneous conclusions:

> "As a result, the essential facts of this appeal are the same as those presented in Net Equity: it is the same Ponzi scheme, the same perpetrator, and the same method of generating fictitious account statements. In other words, these are the same 'extraordinary facts' that we found warranted the Net Investment Method in the first instance." (App.8a)

1. The Panel's Errors

Error number 1: "the same Ponzi scheme."

The net equity case did not establish a Ponzi scheme rule to apply to all Ponzi schemes or Ponzi schemes that are operated by licensed brokers in a heavily regulated industry. Ponzi schemes are not defined in the text of SIPA, and the words "Ponzi scheme" never even appear in the text of SIPA. If Congress wanted to exclude from SIPA's protections victims of Ponzi schemes, it could have done so at any point since 1970. It did not. And, if Ponzi scheme victims were not meant to be covered by SIPC, neither the SEC nor SIPC would have argued in *New Times* (successfully) that customers of a brokerage house which operated as a Ponzi scheme were entitled to the balances on their last statements under circumstances where their broker never purchased the securities shown on their trade confirmations and customer statements.

Error number 2: "the same perpetrator."

The Net Equity Decision did not establish a "Madoff" rule sanctioning the use of the NIM under all circumstances and for every Madoff customer. The Second Circuit limited its ruling solely to Madoff's split-strike customers. In enunciating a "no one-size

fits all" standard, (App.139a) and in recognizing that "differing fact patterns will inevitably call for differing approaches to ascertaining the fairest method for approximating 'net equity,' as defined by SIPA," (App.125a) the Net Equity Decision made clear that the use of a particular formula to calculate net equity was fact dependent and not reliant on the specific individual who perpetrated the crime. In fact, the SEC, which has not intervened herein as it did in 2011, made this point in its opposition to a prior Petition for Certiorari brought by Madoff split-strike customers in 2012 who sought to have this Court overturn the Net Equity Decision, when the SEC stated: "The choice between the Net Investment Method and the Last Statement Method turns on the details of a particular fraudulent scheme," (App.174a) and the Second Circuit in the Net Equity Decision: "emphasized the limited reach of its holding, noting that it was "[t]he extraordinary facts of this case [that] make the Net Investment Method appropriate." (App.164a)

There is simply no way that a customer who does not relinquish full investment authority to the broker but authorizes or directs the trading of specific stocks in their account can be equated with a customer who ceded all control over the account to Madoff.

Error number 3: "the same 'extraordinary facts.'"

The "extraordinary facts" of Madoff's split-strike scheme can in no way be said to be the "same extraordinary facts" that the Panel held, "warranted the Net Investment Method" (App.8A) to be employed to calculate net equity in the Sage Accounts including the SA buy and hold account.

The differences between buy and hold accounts and split-strike accounts are stark. Split-strike accounts maintained by 95% of Madoff's customers according to the Second Circuit and the Trustee's expert involved extraordinary facts because split-strike customers:

a. Ceded all investment authority to Madoff giving him full control to buy, sell, and determine the profit in his scheme. (App.117a);

b. Received profits rigged to reflect steady and always positive returns regardless of market swings, (App.131a);

c. Received annual rates of return of 10-20% from 1996 on despite market downturns and volatility (SDNY Case 20-cv-10057 Document 104 at 358-359); and

d. Never had a negative month or a negative year, even in 2008 before BLMIS declared bankruptcy,(SDNY Case 20-cv-10057 Document 104 at 374-375).

Madoff's split-strike was extraordinary because it was "devoid of any connection to market prices, volumes, or other realities." (App.104a) and was "impossible" (App.139a,140a) to execute in the real world as whistleblowers have shown.[7]

Further still, Madoff's split-strike scheme was extraordinary because it was his own design and invention which he conceded in his plea allocution (SDNY Case 20-cv-10057 Document 68-5 at 25) was seen

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[7] *Ibid.* See thirty red-flags involving Madoff's split-strike scheme uncovered by whistleblower Harry Markopolos in *The World's Largest Hedge Fund is a Fraud.*

as illegitimate by experts, was unknown in the brokerage and trading worlds, and escaped detection by the regulators and auditors over three decades.[8]

On the other hand, customers like SA who maintained a buy and hold account with their licensed stockbroker, including even Bernie Madoff engage in:

1) The "simplest stock strategy that you can have," what "millions of market participants do every day," and is "a long-term investment strategy," according to the Trustee's expert. (SDNY Case 20-cv-10057 Document 104 at 350-351), and

2) A strategy which is "fundamentally (about) whether the stock grows to a point in growth value that you feel you've accomplished the objectives and then . . . you'll make a determination to sell," (*Id.* at 351) according to the Trustee's expert.

The facts in SA were not "extraordinary" at all, as can be easily observed not only from what distinguishes the characteristics of SA's buy and hold account from a Madoff split-strike account, but in light of the Net Equity Decision which made clear in the very first fact adduced in the case background that: "When customers invested with Bernard L. Madoff Investment Securities LLC . . . they relinquished all investment authority to Madoff." (App.117a) In SA's buy and hold account, SA never relinquished investment authority to Madoff, and in fact directed trading of securities in

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[8] SEC Office of Investigations, *Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi Scheme*, Report No. OIG-509, August 31, 2009; https://www.sec.gov/files/oig-5090.pdf.

the account and authorized or directed the purchase of specific stock in the account.

Hence, the finding by the Panel that the "extra-ordinary facts" of the Net Equity Decision were the "same extraordinary facts" as the SA buy and hold account and therefore should be subjected to the extra-statutorily based NIM is clearly erroneous and constitutes reversible error.

Finally, the Circuit Judges who participated in the oral argument in the Net Equity Decision did, in fact, see a buy and hold situation as being distinct from the facts surrounding split-strike and not giving rise to the NIM.

The following exchange took place between Circuit Judges' Raggi, Jacobs, and the Counsel for the SEC, Mr. Conley, at oral argument in 2011:

> Judge Raggi asked: "What if the arrangement with the client, instead of it being buy whatever you think is in my best interest, had been in one stock, buy it and use all dividends and whatever to buy more, over a 30-year period. Would the customer not have a position equal to the last statement in that security?"
>
> The SEC's lawyer, Mr. Conley, responded: "I think what you're talking about here, Your Honor, is something that's quite akin to the folks in *New Times* who weren't the subject of the case, the ones who had a specific investment that they believed they were being put into, which were the real mutual funds."
>
> Judge Raggi then stated: "But with a direction for constant repurchase-"

> Mr. Conley stated: "Exactly. And it's a buy and hold kind of situation. And I think that's exactly what transpired there. And although the Court didn't have to speak to it, SIPC and the Trustee in that case saw that, yes, in that circumstance I understood that my money was being invested in a specific security, I received confirmations and account statements which indicated that, and I am entitled to the additional reinvestment credits over time, and I would have the value, I would be entitled on the filing date of the liquidation proceeding to the value of that security or those securities on that date. And that's exactly what happened in New Times. Although as I say, not the subject of appeal.
>
> Then Judge Jacobs stated: "So the distinction you draw between *New Times* and the circumstances of this case is in *New Times* with respect to some of the people who were put into real stocks, you can, looking at folks' records, account statements and market prices, you can actually calculate –"
>
> Mr. Conley stated: "Precisely, Your Honor." (App. 69-70, Oral Argument, 3/3/2011)

SA was a buy and hold account, which was exactly what Judge Raggi spoke of and Mr. Conley confirmed. What made the transactions possible in SA was that the stocks that SA authorized or directed tracked the returns of the securities in the marketplace. The stock prices in SA were tethered to market prices. Even the Trustee's expert conceded that, over three decades of trades in SA's account, there was only one trade price anomaly. SA's principal, Malcolm Sage, testified to

this, and his testimony was unrefuted and conceded to. In a buy and hold account like SA where stocks were held for indeterminate and lengthy periods of up to 22 years, Madoff could not determine profit in advance because no one could.

Error number 4 - The Same Method of Generating Fictitious Account Statements

Madoff could not create the same kind of fictional fraud in SA's buy and hold account because SA never relinquished its full investment authority to Madoff but rather authorized or directed the trading of specific stocks in their account.

SA's statements reflected its authorizations or directions, had all the indicia of real trading, were fully connected to market prices and volumes, comported with data in recognized publications which compile market information for the investing public to track their holdings, reflected the ups and downs of real market movements, were not fabricated positive steady returns, and had no trading irregularities except for one lone stock mispriced in 26 years.

The Panel did not challenge any of the facts above but wrongly accorded significance to the fact that the confirmations and account statements used after the fact historical pricing. However, those prices merely resulted in establishing a purchase or sales price for the stock.

So unlike in split-strike where Madoff could use after the fact historical pricing constructs to effectuate a predetermined always positive return and profit for his split-strike scheme involving a contrived hedge

incorporating options, he couldn't have done so in SA's simple buy and hold account where he had to follow SA's instructions. Whether or not, the trades were posted on SA's account fully contemporaneously or by using historical pricing within a very narrow time frame, Madoff could not generate statements for a buy and hold account in the same fictitious way he did in the split-strike accounts for SA.

There is no mention in SIPA's net equity definition or anywhere in SIPA of fictitious or fraudulent statements. Critically, the whole reason for the statute, in the absence of tangible stock certificates, was to safeguard a customer by allowing him in a virtual market, to rely on trade confirmations and account statements provided by the broker.

Error number 5 – "rigged to reflect a steady and upward trajectory in good times and bad." (App.6a)

The Panel cited as a "powerful" reason for permitting the use of the NIM to calculate net equity that the trades in SA's account "were rigged to reflect a steady and upward trajectory in good times and bad." There was no such evidence; nor could there have been because SA's account was tied to actual market prices.

Indeed, the District Court never stated that the trades in SA were rigged to reflect a steady and upward trajectory in good times and bad as the statements themselves manifestly showed that such was not the case. SA did not show a steady upwards trajectory but instead, showed annual losses in six years and monthly losses in 126 months out of the 300 months between 1982 and 2008.

Error number 6 – non-engagement in the market

The Panel mistakenly permitted the use of the NIM saying that: "The dispositive factor was that, in perpetrating a Ponzi scheme, Madoff never engaged in the represented market activity, and—like here—he authored after-the-fact account statements in furtherance of the scheme." (App.7a). This is contrary to:

a. The testimony of the former President/CEO of SIPA, Stephen Harbeck in *In re New Times Securities Services, Inc.* No 00-8178 (Bankr. E.D.N.Y. 7/28/00, filed 9/26/00) Tr. at 37-39:

> 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!

b. The statement of Josephine Wang, current President/CEO of SIPC, just five days after the Madoff brokerage failure:

> " . . . 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," and "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,"[9]

c. SIPA, which does not state the non-purchase of securities excludes coverage in situations where a stockbroker failed to purchase stock on behalf of a customer. (15 U.S.C. § 78fff-2(b) requires only proof of the broker's "obligations" to the customer but does not require proof that the broker purchased the securities owed to the customer.), and

d. SIPA's legislative history:

   i. "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." H.R. Rep. 95-746 at 21 (1977) (emphasis added).

   ii. "Under present law, because securities belonging to customers may have been lost, improperly hypothecated, misappropriated, never purchased or even stolen, it is not always possible to provide to

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9 Laurence Kotlikoff, Professor at Boston Univ., *Why brokerage account insurance is a bigger scam than Madoff*, PBS NEWSHOUR, June 26, 2014, www.pbs.org/newshour/nation/why-brokerage-account-insurance-is-a-bigger-scam-than-madoff

> customers that which they expect to receive, that is, securities which they maintained in their brokerage account." S.Rep.No.95-763, at 2 (1978).

There was no change in the plain language of the statute or the legislative history of SIPA which could justify the Panel's ruling against SA.

Finally, if the Circuit in the Net Equity Decision intended to set out, as the Panel did in the SA case, that what was "dispositive" of choosing a formula to establish net equity was whether or not, a licensed broker "engaged in the represented market activity," (App.7a), the Circuit could have simply said that the entire Madoff fraud (or any fraud) would be governed by resort to the NIM under circumstances where a licensed but rogue stockbroker commits to, but does not purchase equities for his customers. It did not, but rather, it set out a host of critical factors that needed to be evaluated before making clear that "resort to the NIM would be rare." (App.132a)

Error number 7 - The Panel committed reversible error in stating that the NIM was "the most reasonable" method to calculate net equity:

> "We ultimately sided with the Trustee, reasoning that the Net Investment Method was the most reasonable calculation method because, under Madoff's scheme, 'the profits recorded over time on the customer statements [of SA] were after-the-fact constructs that were based on stock movements that had already taken place, were rigged to reflect a steady and upward trajectory in good times

> and bad, and were arbitrarily and unequally distributed among customers.' (App.131a)" (App.5a-6a)

This statement by the Panel is clearly erroneous and without foundation. In numerous time periods, unlike in spilt strike where values always increased, SA's account reflected losses. Thus, what might have been appropriate for split-strike customers was not appropriate for SA which authorized or directed its own stock purchases. The Circuit in the Net Equity Decision never said that the NIM was "the most reasonable calculation method," nor did it say that it's use was permissible beyond its application to the split-strike customers, absent statutory authority just because it was a "legally sound technique." (App.5a). It simply applied a methodology for one set of facts, split-strike, calling the standard "superior to the Last Statement Method as a matter of law." (App.131a, fn7)

It makes no sense to apply the same remedy to an entirely different set of facts given that the Net Equity Decision was a limited fact determinant holding. It is unrefuted that SA did not relinquish full investment control to Madoff and that SA directed trading of securities in the account and authorized or directed the purchase of specific stock in the account.

Further, there is no statutory grant of discretion to SIPA or to a SIPA trustee to calculate net equity based on "practical" considerations. In *In re Bernard L. Madoff Inv. Securities LLC*, the Bankruptcy Court in recognizing the magnitude of Madoff's fraud which resulted in 15,000 claims and the evaporation of $73.1 billion, adopted the NIM noting that: "While the Court

recognizes that the outcome of this dispute will inevitably be unpalatable to one party or another, notions of fairness and the need for practicality also support the Net Investment Method." (*In re Bernard L. Madoff Investment Securities LLC*, 424 B.R. 122 at 140,141 (2010))

It is neither the magnitude of the brokerage houses' failure, nor the practicalities or reasonableness that are determinative of calculating the statutory term, net equity, for a buy and hold account.

Error 8. "Using the Last Statement Method would limit the total customer property fund pool."

The Panel, embracing the language of the Net Equity Decision verbatim, cited equitable concerns in favor of employing the NIM as "the most reasonable method" (App.5a) to calculate net equity: "We also found that using the Last Statement Method would limit the total customer property fund pool and mean that" (App.6a) "those who had already withdrawn cash deriving from imaginary profits in excess of their initial investment would derive additional benefit at the expense of those customers who had not withdrawn funds before the fraud was exposed." (App.131a)

This concern disregarded seven key foundational items:

a. The Net Equity Decision was limited to split-strike

The Net Equity Decision, employing the NIM, was limited to the "extraordinary facts" of Madoff's

split-strike scheme and made no mention of customers buying and selling individual stocks in a buy and hold account. (*See* the colloquy between Judge Raggi, Judge Jacobs, and the General counsel for the SEC, supra. at 23-24 indicating that the employment of the NIM for buy and hold accounts was specifically evaluated and rejected at oral argument).

b. There is no statutory grant of "equitable" discretion to SIPC, a SIPA trustee, or a court of law

Neither the Court's nor the Trustee's views of fairness, (or even "compassion"[10]) can justify ignoring the plain meaning of a statute, especially when what constitutes fairness and equity is subjective and fact dependent. First, customers' net equity claims must be based on applicable law—not "undefined considerations of equity." *Butner v. United States*, 440 U.S. 48, 55-56 (1979). Second, neither the Trustee nor the Court below was "authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements." *Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 24-25 (2000).

c. SIPA and the Bankruptcy Code are not inequitable statutes

Applying SIPA and the Bankruptcy Code compatibly with customer expectations is the only truly equitable outcome. Equity in the law is the consistent

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10 *See* statement of Trustee Irving Picard and SIPC CEO Stephen Harbeck, *Another View: Unwinding Madoff's Fraud.* Dealbook, NEW YORK TIMES, May 6, 2009. "The trustee and S.I.P.C. are committed to a fair, equitable and compassionate approach to the allowance of customer claims."

application of legal rules. The definition of inequity is unequal application of norms. Critically, disrupting or destroying the lives of innocent buy and hold customers in a manner fully at odds with decades of legitimate customer expectations constitutes the essence of inequity because buy and hold customers were not similarly situated to the split-strike customers, and their legitimate expectations were distinctly different. And, in this case, the fact that SA chose to purchase, invest in, and hold many equities over lengthy periods of time, should never have placed SA in the same class as an investor in Madoff's split-strike scheme where securities were always liquidated on a short-term basis and where Madoff could always manipulate the outcome because unlike in SA, he controlled both the purchase and the sale.

d. It is unreasonable to depart from the plain language of a statute to treat claimants with disparate fact patterns the same way

Especially in cases where the plain language of a statute indicates the employment of one method of calculation, but an extra-statutory one is imposed for reasons of equity, both a SIPA Trustee and a reviewing court are obligated to distinguish between claimants so as not to achieve the very inequity SIPA seeks to avoid. In *United States v. Noland*, 517 U.S. 535), at 540-541 (1996), this Court held that courts: "are not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." Thus, at the very least, the Trustee, the District Court, and the Panel, needed to evaluate and weigh the differences between Madoff's split-strike scheme, and

a customer who managed a buy and hold account. Failure to do so was legal error and clearly erroneous.

e. Neither SIPC nor a SIPC Trustee is empowered by SIPA to invent a framework not established in a statute or even its legislative history

The SIPA statute did not give the Trustee the power to invent a new framework to compensate victims of a failed brokerage. In rewriting the statute to limit recoveries because SIPC inadequately capitalized the customer protection fund, the Trustee needed to come up with the cash to achieve his goal. He accomplished this by creating liability for those who took out more money than they put in. However, in doing so for investors like SA, who held and actively managed a simple buy and hold account, the Trustee's conduct was inconsistent with SIPA and inequitable as well.

f. Unless expressly authorized by statute, no Trustee can selectively choose which customers to collect from, which customers to absolve of liability. Critically, where, as here, a Trustee does so arbitrarily, capriciously, and inconsistent with his own established rules, there is no justification to selectively pursue customers

The Trustee's conduct herein in regard to selecting which individuals associated with SA and SR to seek clawback against was inconsistent with his own rules. The Trustee held the three Sage siblings personally liable for the debts of the four other family members

who withdrew monies in the two-years prior to bankruptcy from SR. One of these other family members withdrew nearly three million dollars (approximately 80%) of the total SR withdrawal) in the two-year period. Nevertheless, the Trustee gave this family member complete absolution for his entire withdrawal and obtained a judgment in the amount of his withdrawal from the three siblings who had no legal or equitable right to the withdrawal and never received any proceeds of this other family member's withdrawal and could not have. By proceeding in this manner, the Trustee engaged in selective prosecution for which there was no justification in law or in equity. No Trustee or fiduciary can establish a formula and depart from it because he prefers to collect money from one individual rather than another, when even his own established rules, provide otherwise.

g. SIPA does not provide for strict liability of all customers who are defrauded by a broker because of his failure to purchase the stock he commits to buying

In the view of the Trustee, the SIPA statute provides for strict liability for all innocent customers of a failed brokerage house under any set of circumstances where the licensed broker did not engage the market. However, in employing the NIM, both the District Court and the Panel ignored the constraints imposed upon the Trustee under the Second Circuit's ruling in the Net Equity Decision and the plain language and legislative history of SIPA which do not support the Trustee's one size fits all position.

What defies understanding is that the two-year measuring period relating to withdrawals is statutorily enforced and has no elasticity, but the willingness to introduce an extra-statutorily based formula with no time restraints whatsoever is countenanced based on an assertion of what is "equitable" in the eyes of the SIPC Trustee (whose law firm has been paid, to date, over $1.5 billion).

REASONS FOR GRANTING THE PETITION

In 2011, the Second Circuit allowed the Trustee to ignore the plain text of SIPA which was intended to shield customers of a failed brokerage firm by assenting to the use of an extra-statutory methodology to calculate net equity under narrow circumstances for Madoff's split-strike customers only because of the extraordinary facts of that scheme.

The District Court and the Panel herein:

a. likewise ignored the plain text of SIPA by employing the NIM to calculate net equity for customers who maintained a buy and hold account.

b. ignored the decision of Judge Nathan who questioned whether the NIM was even "permissible" under SIPA.

c. ignored the Circuit's decision to employ the NIM to calculate net equity but only under narrow circumstances and only for one specific group of customers who gave all investment authority to Madoff.

. . .

d. erred in allowing the Trustee to unilaterally decide which concededly innocent customers to selectively collect from even outside his own devised formula to calculate net equity.

Hence, the Courts below, at the behest of the Trustee, exceeded their power and authority under 15 U.S.C. §§ 78aaa *et seq.*

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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