STATEMENT
OF
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Introduction

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee, thank you for the opportunity to appear before you today on behalf of the Securities and Exchange Commission to discuss the Securities Investor Protection Act of 1970 (SIPA), and specifically the Commission's views regarding the liquidation of Bernard L. Madoff Investment Securities LLC being conducted by the Securities Investor Protection Corporation (SIPC). My name is Michael Conley, and I am the SEC's Deputy Solicitor.

Before I discuss the legal issues that are the focus of my testimony, I want to make clear that the Commissioners and staff of the SEC are keenly aware of the devastating losses that Madoff's fraud has caused to the thousands of investors who entrusted him with their money. We know that many—if not most—of Madoff's victims have had their lives up-ended. At the SEC, Chairman Schapiro has urged all of us to learn from the experience and reform the way we operate. Already, we are revitalizing our Enforcement Division, revamping the way we handle tips and complaints, seeking whistleblower authority, creating a new division to focus on risk, expanding training, seeking adequate and reliable funding, and hiring more personnel with skill sets critical to addressing new challenges that face investors and the capital markets. In response to the Madoff matter, we proposed rules to better protect clients of investment advisors from theft and abuse by assuring clients that their accounts contain the funds that their investment advisers and account statements say they contain.

With regard to issues concerning the Madoff liquidation, I can assure you that the Commission and its staff have been and remain committed to ensuring that Madoff investors' interests are protected in the ongoing liquidation proceeding. Claims for losses suffered by the Madoff investors are determined under SIPA, but the statute does not provide a clear answer to some key questions related to claims by Madoff account holders. In particular, the statute does not expressly address how to calculate the "net equity" in a customer's account when a broker-dealer has engaged in the sort of fraudulent scheme Madoff perpetrated here. The answer to that question is essential to determining the proper value of the Madoff customers' claims. The bankruptcy court will soon hear arguments on the competing theories of valuing customer claims that have been advanced by claimants and the SIPC Trustee. My testimony describes the structure of SIPA in protecting brokerage customers, the existing case law, the competing theories of claim valuation in the Madoff case, and the views of the Commission regarding the appropriate way to measure "net equity" on the facts of this case.

The Commission appreciates the real world consequences of the bankruptcy court's decision on how customers' claims should be valued. The recommendation the Commission will make to that court is based on what the Commission believes is the best reading of SIPA and the decisions that have interpreted that statute. The Commission is cognizant of the fact that the total pool of customer money available to distribute to claimants is limited. Unfortunately, we know that there will not be enough money in that pool to compensate all the victims for their losses. As such, the customer money allocated to one Madoff victim will affect the money that is available to compensate other victims. The bankruptcy court's task—and the Commission's goal in making its recommendation—is to arrive at the fairest way, consistent with the law, of dividing that limited pool of money.

The Securities Investor Protection Act

Congress enacted SIPA in 1970 after serious and persistent financial problems in the securities industry led to a number of brokerage firm bankruptcies that resulted in substantial losses by those firms' customers. The statute was designed to protect brokerage customers when a firm fails and cash and securities are missing from customers' accounts. Congress wanted to ensure that when brokerage firms fail, customers could quickly obtain the cash and securities that should be in their brokerage accounts or receive some measure of compensation if those assets were missing. By establishing those protections, Congress sought to avoid the inevitable weakening of confidence in the U.S. securities markets that would occur if customers were afraid to entrust their funds and securities to broker-dealers.

Through SIPA, Congress created SIPC, which is a membership corporation made up of securities broker-dealers registered with the SEC. Generally, SIPA requires the SEC, the Financial Industry Regulatory Authority, and other industry self-regulatory organizations to inform SIPC when a brokerage firm is approaching financial difficulty. If SIPC then determines that the brokerage firm has failed or is in danger of failing to meet its obligations to customers, SIPC may then bring a customer protection proceeding for the purpose of returning to the firm's customers the cash and securities that are owed by the firm to its customers even if those securities are missing. SIPC designates a Trustee and counsel, who are appointed by a federal district court judge, and then the matter is referred to the appropriate bankruptcy court to oversee the firm's liquidation.

As part of that proceeding, the failed brokerage's customers have claims for net equity based upon securities and cash shown on the books and records of the brokerage firm or otherwise established to the satisfaction of the Trustee. After the Trustee determines a customer's net equity claim, the Trustee satisfies the claim with a *pro rata* distribution from customer property. The term customer property includes all of the cash and securities that the broker-dealer received or acquired from customers or for customers' accounts, and the proceeds of any property transferred by the brokerage firm (including property unlawfully converted). The Trustee attempts to recover as much missing property as possible, which can include bringing preference and fraudulent transfer actions.

If the amount of securities and cash in the fund of customer property is inadequate to satisfy customers' net equity claims, the Trustee makes payments from the SIPC Fund of up to $500,000 per customer to cover claims for missing securities and cash—with coverage for missing cash limited to $100,000. The SIPC Fund, which currently has assets of approximately $1.2 billion, is funded through assessments on SIPC's member firms. If the Fund is insufficient to satisfy customer claims, SIPC may request a loan from the SEC. The SEC, in turn, is authorized under SIPA to issues notes or other obligations to the Secretary of the Treasury, up to $1 billion, to obtain the money to loan to SIPC. Typically, customers first receive payments from the SIPC Fund, and thereafter receive payments from the fund of customer property as assets are recovered over the course of the SIPA proceeding. In the case of Madoff, customer property, even after it is supplemented by payments from the SIPC Fund, will not be sufficient to satisfy customers' net equity in full.

Congress amended SIPA in 1978 to require that, where possible, trustees satisfy claims for securities that are missing from customer accounts with actual securities, rather than paying their value as of the date the SIPC proceeding was filed. Both the Senate and House reports on the 1978 amendments make clear that SIPA's protection extends to securities that are not in the account because the broker never purchased them, even though the customer ordered the purchase and the trade was confirmed by the broker.

Although it is clear that SIPA does not cover losses by customers who are fraudulently induced to purchase or sell securities, SIPA *does* protect against fraudulent conduct when it involves the conversion of funds that customers intended to be used for securities purchases.

Case Law

In the case *In re New Times Securities Services, Inc.*, 371 F.3d 68 (2d Cir. 2004), the Second Circuit addressed a question Congress did not consider when it enacted SIPA: to what extent does SIPA apply when a brokerage fails after taking customer funds based on a promise to invest in specified securities that turn out to be fictitious? The case involved a Ponzi scheme in which customers were solicited to invest in money market funds. Several of the funds (Vanguard and Putnam) were real funds, but another group of funds (the New Age funds) did not exist and were simply fabricated by the promoter. In all cases, the money was never invested, but converted by the firm's principal, Charles Goren, for his own use.

The Second Circuit agreed with SIPC that the net equity of the New Times customers who were told that their money would be invested in the Vanguard and Putnam funds (and whose account statements falsely showed that such purchases had been made) should be calculated differently under SIPA than the net equity of the customers who were told their money was being invested in the fictitious New Age funds. The investors who gave Goren money to purchase Vanguard and Putnam money market funds were in the same position as any customer whose broker simply fails to make an investment that has been confirmed by the broker-dealer. Under settled law, those customers' net equity reflected the market value of the Vanguard and Putnam securities that had been paid for and were shown on their account statements but, in fact, had never been purchased.

But the Court concluded that the customers who were solicited to invest in the non-existent New Age funds were in a different position. Because those securities were fictitious and could never have been acquired, the Court held that basing net equity on the fabricated returns shown on customer account statements would be inconsistent with SIPA. Instead, the Court concluded that those customers' net equity should be calculated based on their initial cash investment—which served as a "proxy" for the securities the customers believed they were purchasing.

The Madoff case

The Madoff liquidation does not fall neatly within the situations expressly addressed by SIPA or dealt with in cases interpreting the statute. The Madoff case involves a variation of the fictitious investment scenario addressed in *New Times* and raises a new question: how does SIPA apply when customers' brokerage statements show non-existent positions in real securities that the broker concocted *after the fact* to support pre-determined fictional investment returns? Although Madoff claimed to have developed a so-called "split-strike conversion strategy," the strategy was in fact a complete fraud.

Madoff instructed his key lieutenant, Frank DiPascali, to generate credible annual returns for the strategy of between 10 and 17 percent. DiPascali implemented the strategy by periodically selecting—after the fact—weighted baskets of stocks in the S&P 100 index and booking fictitious trades in these stocks to achieve Madoff's targeted returns. With the benefit of hindsight, DiPascali picked advantageous historical prices, with purchases often near the lows and sales near the highs, to create the appearance of a profit.

A computer allocated the fictitious trades to individual Madoff customer accounts and generated separate trade confirmations and account statements for each account based on its *pro rata* share of the purported trading. None of the transactions shown on the customers' account had been requested by the customer, and none of the transactions actually occurred. Instead, Madoff was operating a classic Ponzi scheme in which the invested funds of newer investors were converted and used to pay fictitious returns to older investors to keep the scheme from being discovered.

Methods for Valuing Customer Claims

Two primary approaches have been proposed for establishing the value of claims by Madoff customers. The first is known as the "final account statement method." Under this method, it is argued that the net equity in customer accounts should be based upon the securities positions shown on the final account statements customers received before the Madoff firm was placed in liquidation. Because customers rely on the information in their account statements to keep track of their investments, proponents of this method contend that these documents reflect their "legitimate expectations" of what was in customer accounts when the Madoff firm failed.

The second principal approach to resolving customer claims is the "cash-in/cash-out" method. Proponents of this method contend that because the account statements show fictitious transactions and returns that are part of an overall fraudulent scheme, the securities positions shown on those statements are not a legitimate basis for determining the customers' net equity. Instead, they argue that net equity must be determined by crediting the amount of cash the customer deposited in the account, and subtracting any amounts withdrawn from the account.

Madoff's firm was placed in a SIPA liquidation proceeding in early December 2008. The Trustee informed Madoff's customers at the official meeting of creditors on February 20, 2009, that claims would be based on the cash customers had invested less the cash they had withdrawn —the cash-in/cash-out method. Many customers have filed objections to the Trustee's determinations. Most of those customers contend that their net equity should be based upon the securities positions shown on their final account statements. The bankruptcy court currently is in the process of resolving the dispute between the Trustee and the objecting claimants over which of the two methods should be used.

There is no dispute that the Madoff customer claims are to be treated as claims for securities for purposes of the SIPA limits and thus are eligible for up to $500,000 from the SIPC Fund. The critical question is how to calculate the customers' net equity. The answer is not immediately apparent, as the facts here differ from the typical SIPC case in which courts have concluded that customers' net equity can be determined by the securities positions shown on the customers' account statements.

That was the situation with the *New Times* customers who directed the broker to invest in the Vanguard and Putnam funds. The broker had committed to buy specific existing securities, and customers paid for those purchases. The broker did not buy those securities, though he sent out confirmations and account statements that purported to show the purchase of those securities. There, the customers' net equity was based on the value, as of the date the SIPA proceeding was filed, of the securities shown on their account statements. Those statements accurately reflected the securities positions that the customers had instructed the broker to purchase and expected to be in their accounts. By contrast, the account statements and confirmations Madoff sent to customers reflected fabricated securities positions, based on hindsight, that were designed to facilitate his fraudulent scheme. Most Madoff customers expected that he would invest their money through legitimate trading in real securities. Instead, through no fault of those customers, Madoff opted out of the market in favor of a wholly fictitious series of transactions with pre-determined outcomes.

The situation also is not exactly like that of the customers in *New Times* who were solicited to invest in the non-existent New Age funds. There, the court concluded that the customers' net equity could not be based on the fictitious amounts shown on their account statements because basing recovery on the transactions in non-existent securities reflected on those statements would allow customers to recover amounts that had no relation to reality. In this case, by contrast, the securities on the account statements Madoff sent to customers were real securities.

The question the bankruptcy court will have to resolve is whether the Madoff brokerage customers are more like the *New Times* customers who directed the broker to purchase securities that actually existed (which would support the final account statement approach to calculating net equity) *or* more like the *New Times* customers who directed the broker to invest their money in securities that turned out to be non-existent (which would support the cash-in/cash-out method of calculating net equity).

The SEC's Recommendation

The Madoff case raises difficult issues. Based on an analysis of SIPA, its legislative history, and cases that have applied it, the Commission is recommending to the bankruptcy court that customer claims should be determined through the cash-in/cash-out method advocated by the Trustee and SIPC—with an additional adjustment to ensure that the investors' claims in this long-running scheme are valued most accurately and fairly.

The Commission is basing its recommendation on the conclusion that the claims of the Madoff investors cannot be valued based on the balance shown on their final account statements. Although this approach would allow most Madoff account holders to receive payments on their claims, those payments would be based on account balances reflecting amounts that Madoff himself concocted that bear no relation to reality. The account statements Madoff sent to the customers showed the results of a Ponzi scheme designed as an investment program, with positions selected *after the fact* to produce pre-determined results. Neither SIPA nor any of the cases interpreting that statute can be read to support an approach that would value claims based on the fictitious investment returns of such a scheme.

Madoff essentially promised customers that he would pick "winning" stocks for them, did not tell them which stocks he would purchase, waited to see which stocks did well, and then falsely reported that he selected stocks that met their investment expectations. The account statements that Madoff sent to his customers were illegitimate tallies of a fraudulent scheme and provide no basis for calculating those customers' net equity. Therefore, the Commission has concluded that the most reasonable way to measure the value of the Madoff customers' net equity is to look to the money those customers invested with Madoff as a proxy for the *unspecified* investments in securities (the split-strike conversion strategy) Madoff told them he would make for their accounts.

The Commission's recommendation resembles what would likely be the outcome in a private suit by a customer challenging the distribution of assets on the same facts. Although the customer could establish that the broker had committed fraud, and could recover her initial investment (less withdrawals), she would not be able to recover as damages the amounts shown on the final account statements because they were based on fraudulent backdating of trades through hindsight. The fraud did not cause the customer to lose actual proceeds that were (or could have been) the product of legitimate trading. The same principles are relevant in calculating the Madoff customers' net equity under SIPA. In this case, the only reliably determinable transactions are the cash deposits and withdrawals those customers made to and from their brokerage accounts.

By contrast, where a customer directs a broker to buy a specific security, the customer pays for that security, and the broker does not buy the security but sends a false confirmation of the transaction to the customer, the customer presumably could obtain a judgment in a private action requiring the broker either to purchase the missing security for the customer's account or to pay the customer the current market value of the security. On the same facts, a customer's net equity under SIPA would likewise reflect the market value of the security the broker committed to buy, the customer paid for, and the broker-dealer falsely confirmed having purchased. In such a situation, the Trustee would either go into the market and buy the security for the customer's account or credit the customer with the market value of the security as of the filing date.

In addition, it is important to note that basing customers' net equity on the fictitious balances on their final account statements would do nothing to increase the fund of customer property—it would simply reallocate it. It is clear that there will not be enough money in the fund of customer property to pay out the $65 billion that Madoff falsely reported was in customer accounts when the firm failed. The Trustee has estimated that he may be able to recover as much as $8 billion to distribute to claimants. Using the final account statement approach would have the effect of favoring early investors—many of whom withdrew all or more than the principal they invested with Madoff—over later investors—some of whom withdrew little or none of what they invested and will not receive a distribution equal even to their principal.

While the final account statement approach favors earlier customers at the expense of later customers, the SEC is also sensitive to the corresponding fairness concerns under the cash-in/cash-out method. That method of calculating net equity favors later customers at the expense of earlier customers by treating a dollar invested in 1987 as having the same value as a dollar invested in 2007. To illustrate this concern, assume that one claimant invested $100 in the Madoff firm in 1987, a second claimant invested $100 in 2007, and neither withdrew any funds from their accounts. Under the cash-in/cash-out approach advocated by SIPC and the Trustee, the net equity of both claimants would be $100. But because, in basic economic terms, $100 in 1987 dollars is worth $183 in 2007 dollars (http://data.bls.gov/cgi-bin/cpicalc.pl.), the claimant who invested $100 in Madoff's firm 21 years before the firm collapsed has suffered a much more substantial real-world loss than a claimant who invested $100 only one year before the collapse.

In the SEC's view, to achieve a fair and economically accurate allocation among Madoff customers who invested and withdrew funds in different historical periods, it is appropriate to convert the dollars invested into "time-equivalent" or constant dollars. This constant-dollar approach is rooted in the classic economic concept of the time value of money and will result in greater fairness across different generations of Madoff investors—in effect, treating early investors and later investors alike in terms of the real economic value of their investments.

The issue of calculating net equity in constant dollars has not arisen before in SIPA cases, probably because many Ponzi-type schemes are of relatively short duration, and the inequity among those who invested at different points in time is less striking. But the Madoff fraud—which lasted for 20-plus years—puts this issue into stark relief. In light of the silence of SIPA regarding the payment of interest and of a Court of Appeals decision[1] suggesting, in a distinct factual circumstance, that interest may not be applied to customer claims under SIPA, the Commission considered whether calculating net equity in constant dollars would be inconsistent with that case. Under the facts of this case, the Commission believes that the use of constant dollars can be distinguished from the payment of interest discussed in that Sixth Circuit case and

[1] *SIPC v. Ambassador Church Fin./Dev. Group*, 788 F.2d 1208 (6th Cir. 1986) (holding that customers of a failed brokerage could not obtain post-judgment interest for the 7 ½-year period during which SIPC delayed in paying their claims because SIPA's definition of "net equity" does not expressly provide for interest).

that the best reading of SIPA and the cases interpreting it is that net equity here should be calculated in constant dollars.

It also is the Commission's view that the constant-dollar method will have limited application to the calculation of net equity in other liquidations under SIPA. In a SIPA liquidation, a claimant's net equity is determined by calculating the net value on the filing date of the securities positions and cash shown on the books and records of the broker-dealer. Where the claimant's account statement and the books and records of the broker-dealer are consistent, there is no need to adjust that net equity value for inflation, because it is determined in current dollars as of the filing date. Calculating net equity in constant dollars should be necessary only where (1) the customer has a claim for securities, and (2) the claimant's account statement does not match the books and records of the broker-dealer either because (a) the securities are fictitious, or (b) the securities positions were the product of a fraudulent scheme. In calculating the customer's net equity under these circumstances, as in *New Times*, the money that the customer gave the firm to purchase securities serves as a proxy for the securities positions that were not and—critically—could not legitimately have been purchased. When the customer's net equity is calculated using cash as a proxy for securities positions, it is appropriate to calculate net equity in constant dollars.

Conclusion

The Madoff case poses difficult questions regarding the appropriate method for calculating the value of customers' claims in the absence of clear direction from either the statute or existing case law. The Commission's recommendation to the bankruptcy court is based on a determination that calculating the net equity of Madoff customer accounts using a constant-dollar, cash-in/cash-out method is most consistent with the purposes of the statute and provides the greatest degree of fairness.

I thank you again for the opportunity to appear before you today. I would be pleased to answer any questions you may have.