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IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT



IN RE: BERNARD L. MADOFF INVESTMENT SECURITIES LLC

ON APPEAL FROM THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF FOR APPELLANTS

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PRELIMINARY STATEMENT

SIPC, the Trustee, and the SEC are seeking a judicial repeal of the remedial provisions of SIPA in order to reduce SIPC's financial obligations to customers and to enhance SIPC's ability to recover on its subrogation claims, to the meager extent that it pays SIPC insurance. Their briefs ignore the following inescapable facts:

1. SIPA defines "net equity" as the balance on the customer's last statement. *See* 15 U.S.C. § 78lll(11).
2. SIPA expressly prohibits SIPC from changing the definition of "net equity." *See* 15 U.S.C. § 78ccc(b)(4)(A).
3. SIPC repeatedly led investors to believe that they were insured based upon their last statement. (Peskin Appellants' Brief at 14).
4. SIPC's Series 500 Rules, 17 C.F.R. § 300.502, provide for the classification of claims in accordance with the "legitimate expectations" of a customer based upon the written confirmations sent by the broker to the customer. Thus, the type of fraud perpetrated by a broker is irrelevant to a customer's entitlement to SIPC insurance. Were this not so, an investor would never know whether his account was insured unless and until he was defrauded and SIPC and the SEC decided if this was the type of fraud they wanted SIPC to cover.

5. After the enactment of SIPA, the investing public relinquished the right to hold certificated securities in their own names, relying instead on SIPC insurance. The only evidence any investor has of what he owns is the confirmations and monthly statements he receives from his broker. SIPC's members, the SEC-regulated broker-dealers, were well-served by SIPA for 38 years because, in that period of time, investors vastly increased their investments in reliance upon the governmental promise of SIPC insurance. Just in the period from 1990 to 2005, the average number of shares traded on the New York Stock Exchange on a daily basis rose from \$.2 billion to \$1.6 billion—an increase of 800%.¹

6. SIPC knowingly and deliberately induced investors to place their life savings in the hands of SIPC's members with the promise of \$500,000 of SIPC insurance against the fraud of a dishonest broker. Yet, SIPC charged its members a token \$150 per year for this service despite repeated warnings from the GAO and Congress that SIPC was seriously under-funded. (Peskin Appellants' Brief at 13). SIPC ignored those warnings and continued to provide its members with, essentially, free insurance. When the Madoff loss occurred, SIPC's assets were \$1 billion

¹ Akira Yasuoka, *Evolution of the US Retail Securities Market*, 1 Nomura Research Institute at 16 (2006).

short of its statutory liability to Madoff's victims.² Instead of borrowing the funds to cover this obligation, as it had the statutory power to do, SIPC invented a new theory of coverage, which it has justified by charging Madoff's victims with Madoff's fraud because they appointed him as their agent in the account opening agreements! (SIPC Brief at 38-46).³ Sadly, the

² See Velvel Reply Brief Addendum at 1-4 (Doc. #325) (Letter dated September 7, 2010 from Stephen Harbeck, President of SIPC to Congressmen Paul Kanjorski and Scott Garrett)(As of 11/30/08, there were 4,459 accounts at Madoff with balances totaling \$64.8 billion. Of that amount, the Trustee has allowed only 2,175 claims relating to 1,893 accounts, with a total allowed value of only \$5,556,299,243.18, on which SIPC has paid out only \$713,037,947.41 as of August 1, 2010. Of the allowed claims, 1,330 claims representing 1,149 accounts were allowed for more than \$500,000; 845 claims representing 744 accounts were allowed for \$500,000 or less.

On April 1, 2009, SIPC began assessing its members $\frac{1}{4}$ of 1% of operating revenues, as it always had the statutory power to do. As a result, it has accumulated assets, as of August 1, 2010, of \$1,228,200,000. If the Trustee is allowed to use his net investment method, SIPC will owe an additional \$175 million. If the Trustee is required to honor the last statement of each investor, SIPC will owe an additional \$1,122,429,906.).

³ SIPC relies upon the holding in *In re Adler, Coleman Clearing Corp.*, 263 B.R. 406 (S.D.N.Y. 2001), for the proposition that Madoff's victims are chargeable with Madoff's fraud. In *Adler, Coleman*, the court was concerned with situations in which "the principal seeks to enforce the transaction so as to avail himself of the fruits of the agent's fraud." *Id.* at 453. That concern is inapplicable here. Unlike the investors in *In re Adler, Coleman* who, after the fraud was uncovered, sought to enforce the fraudulent unauthorized trade in order to reap its benefits, Madoff's customers are merely seeking to recover the proceeds they expected to receive pursuant to their last statements.

SEC has supported SIPC's evasion of its statutory obligations despite its own inexplicable failure to shut Madoff down despite numerous detailed, credible warnings of Madoff's fraud spanning more than 13 years.

7. Appellees' reliance on the "books and records" provision of SIPA is utterly misplaced because a dishonest broker's books and records will never match the fraudulent statements sent to his customers. That is precisely why Congress enacted SIPA. In every case – such as *New Times* – where a dishonest broker fails to buy the securities shown on a customer's confirmations, the broker's books and records will show that the broker does not own the securities belonging to the customer. That is why SIPA expressly provides that SIPC can go into the market and buy securities to give to customers in satisfaction of their insurance claim.

The trustee shall, to the extent that securities can be purchased in a fair and orderly market, purchase securities as necessary for the delivery of securities to customers in satisfaction of their claims for net equities. . .

15 U.S.C. §78fff-3(d). Clearly, if SIPC's liability was limited to the securities owned by the debtor at the time of a liquidation, there would be no reason to go into the market to purchase securities to satisfy customers' net equity claims. Put another way, if SIPC could escape its insurance obligations simply by relying on a broker's books and records, it would

never have to pay SIPC insurance because, in every liquidation, the trustee would simply deliver the customer's securities to him.

8. Under Article 8 of the Uniform Commercial Code, a broker is obligated to maintain sufficient assets to cover its obligations to its customers. "Whether a person has acquired a security entitlement does not depend on whether the [broker] has complied with that duty." NYUCC § 8-501 cmt. 3. Once the broker credits the customer's account with a security, the broker is obligated to honor all the attributes of ownership of that security to that customer, even if the broker does not own the security. NYUCC §§8-501(b), (c).⁴ Thus, the investor is entitled to the securities shown on his statement, whether or not the broker has purchased the securities.

⁴ The SEC argues that the Trustee is not obligated to honor confirmations sent to customers because the confirmations are not "books of original entry" in accounting terminology. (SEC Brief fn. 5 at 11). This is a specious argument. An investor cannot possibly know how a broker records the transactions reflected on the customer's confirmations (although the SEC certainly has access to that information). The broker's obligations to its customer arise from the confirmations sent to the customer; not from any internal book entries by the broker. Nor is there any requirement under SIPA or under Article 8 that stock positions reflected on confirmations sent to customers be entered on "books of original entry." *See, e.g.,* Russell A. Hakes, *UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day?*, 35 Loy. L.A. L. Rev., 661 at 680 (2003)(by statute, an entitlement holder can acquire a security interest when a securities intermediary credits a financial asset to the entitlement holder's security account).

9. SIPC's purported concern with "equity" is a thin veil for SIPC's real motivation, which is to reduce its own exposure and enhance its ability to be repaid through subrogation. SIPC obfuscates the two sources of recovery for a defrauded investor to distract the Court from SIPC's indisputable obligation to insure each customer's investment up to \$500,000. First, SIPC is mandated to "promptly" pay SIPC insurance to each defrauded customer. *See* 15 U.S.C. §78fff-2(c); 15 U.S.C. § 78fff-3(a). Second, a customer is entitled to a distribution from the fund of customer property, but any such distribution is highly speculative both in terms of amount and the date of any such payment. *See* 15 U.S.C. §§78fff-3, 4. Thus, until the Madoff case bankrupted SIPC, the only reliable source of recovery for a defrauded investor was SIPC insurance.⁵

⁵ In response to the Peskin Appellants' citation to seven Court of Appeals decisions referring to SIPC **insurance**, (Peskin Appellants' Brief at 20-21), SIPC cites one Court of Appeals decision and one district court decision for the proposition that SIPC does not provide insurance. (SIPC's Brief at 15). However, in the Court of Appeals decision SIPC cited, *SEC v. Albert & Maguire Sec. Co.*, 560 F. 2d 569, 571 (3d Cir. 1977), the Third Circuit wrote that SIPA "was intended to provide protection for brokerage house customers somewhat similar to that afforded bank depositors by the Federal Deposit Insurance Corporation." In fact, an overwhelming number of courts have recognized that SIPC provides insurance to securities investors. *E.g.*, *Securities Investor Protection Corp. v. Oberweis Secur., Inc.*, (*In re Oberweis Secur., Inc.*), 135 B.R. 842, 845 (B. N.D. Ill. 1991)("SIPC maintains an insurance fund for investor protection."); *Schwartz v. Oberweis*, 826 F. Supp. 280, 286 (N.D. Ind. 1993)("The SDN, rather than enhancing protection to investors, removed the protection provided by the

10. Instead of seeking to mitigate the devastation caused to Madoff investors by its own incompetence, the SEC has joined SIPC's bandwagon in arguing that SIPC insurance does not apply to the last statement of a customer which reflects fictitious profits. Thus, the SEC is creating an

SIPA and **SIPC insurance.**); *City of Cleveland v. Ameriquest Mortg. Sec., Inc.*, 621 F. Supp. 2d 513,534 (N.D.Ohio 2009)(" **SIPC provided insurance** to investors against losses that occurred when one of its members was unable to meet its obligations."); *Flego v. Philips, Appel & Walden, Inc.*, 514 F. Supp. 1178, 1181 (D.N.J. 1981)(" . . . in *Handelman v. Weiss*, 368 F. Supp. 258, 262-64 (S.D.N.Y.1973), the court . . . recognized that **SIPC, a nonprofit organization which administers an insurance program to protect the customers of its members, . . .**"); *Morsemere Sav. & Loan Assn. v. Marston*, 500 F. Supp. 1253, 1261 (D.N.J. 1980)(" . . . FSLIC and FDIC insurance has this year been increased from \$40,000 to \$100,000., just as **SIPC has recently increased its insurance to \$ 500,000.**"); *Lamb v. Connecticut General Life Ins. Co.*, 509 F. Supp. 560,574 (D.N.J. 1980)(" **Provision was included for insurance, like FDIC and SIPC, in case of the financial failure of a plan. . .**"); *In re Omni Mut.*, 193 B.R. 678, 680 (S.D.N. Y. 1996)("**SIPC maintains an insurance fund not unlike the [FDIC].**"); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95, 99 (S.D.N.Y. 1976)("In SIPC liquidation . . . **claims are paid from SIPC's insurance fund or the general assets of the defunct stockbroker.**"); *Securities Investor Protection Corp. v. Charisma Sec. Corp.*, 371 F. Supp. 894, 899 n. 7 (S.D.N.Y. 1974)(" . . . revision of the SIPA should be considered to more fully apprise members of the public that general contract and fraud claims as well as claims for market losses against brokerage houses are not included in **the insurance umbrella afforded by SIPC. . .**"); *Handelman v. Weiss*, 368 F. Supp. 258,263 (S.D.N.Y. 1973)("SIPC **administers an insurance program . . .** "); *In re MV Secs., Inc.*, 48 B.R. 156, 161 (B. S.D.N.Y. 1985)(". . . **SIPC insurance** is already limited in amount . . . "); *United States v. LaScola*, 2007 U.S. Dist. LEXIS 46054 at *6 (D.R.I. June 25, 2007)(" . . . the principal sources of the funds used to reimburse the victims were **insurance proceeds paid by [SIPC] . . .**")(emphasis added in all cases).

exception to SIPC coverage which finds no justification in the statute.

Indeed, the SEC's brief is devoid of any statutory citation for its position.

11. The Trustee relies upon the bankruptcy court's holding that:

The fact that the Trustee may be unable to avoid a transfer in particular circumstances . . . is irrelevant to the Court's finding that the power itself is inconsistent with a distribution scheme that credits the reported products of a fraud.

Decision at 136-37; Trustee's Brief at 43. However, neither the bankruptcy court nor the Trustee addressed the threshold issue that, in his net investment calculations, the Trustee is self-effectuating fraudulent transfer judgments going back 30 – 40 years. Thus, his methodology for calculating claims is a fundamental violation of the investors' right to due process of law. The Trustee has not even attempted to justify his netting out of customer deposits and withdrawals that predate the applicable statute of limitations. The Trustee is obligated to accept the statement balance as of the beginning of the applicable statute of limitations period.

Moreover, it is fundamentally inconsistent with the provisions of SIPA and with the legislative goal of instilling confidence in the capital markets to subject customers of SEC-regulated broker/dealers to avoidance actions for funds they withdrew from their accounts. Regardless of the body of law that has arisen with respect to Ponzi schemes of unregulated broker/dealers, an investor who takes the precaution of investing through an

SEC-regulated broker/dealer is entitled under SIPA to keep any money he withdrew from his account and on which he paid taxes absent evidence that the investor knowingly participated in the broker's fraud.

ARGUMENT

I. APPELLEES INVOKE "EQUITY" AS A GUISE TO ENRICH WALL STREET AT THE EXPENSE OF MAIN STREET

In 2004, Merrill Lynch employed 15,000 registered representatives servicing an untold number of clients.⁶ For a mere \$150 per year, Merrill Lynch was able to induce business for its 15,000 representatives by assuring prospective customers that the honesty of each of those representatives was insured, up to \$500,000 per customer. Everyone loves a bargain but it is unfortunate that the Appellees persist in protecting SIPC's members against the fair cost for the insurance which they advertised to innocent investors.⁷ In the guise of arguing for what is "equitable," Appellees ignore the fundamental insurance protection which every Madoff investor was promised. By allowing SIPC to escape its insurance obligations, the

⁶ Akira Yasuoka, *Evolution of the US Retail Securities Market*, 1 Nomura Research Institute at 16 (2006).

⁷ The additional cost to SIPC of complying with its statutory obligations is approximately \$1.1 billion. That is 7/10 of 1% of the bonuses that a handful of Wall Street firms paid in 2009 – the year they brought the global economy to its knees. (See Velvel Reply Brief Addendum, (Doc. #325) 9/7/10 letter from Stephen Harbeck to Congressman Paul Kanjorski, at 4.)

bankruptcy court was not advancing equity; it was simply providing Wall Street with more money to pay bonuses.

Appellees argue that, if SIPC pays insurance based upon each customer's last statement, it will be allowing Madoff, the fraudster, to determine who wins and who loses. Although catchy, this statement is false and misleading. Each investor controlled the amount in his account by deciding how much to invest and how much to withdraw at any time. Each of the investors' November 30, 2008 statements accurately reflected the amounts invested and withdrawn subject to the income generated from the transactions reflected on the customer's statements.

The truth is that SIPC simply seeks to escape its own financial obligations, using Madoff's fraud as a pretext. SIPC wants the right to decide that it wins and all the investors lose, by depriving every Madoff investor of the SIPC insurance to which he is entitled. Any ultimate recovery from the fund of customer property will be of little value to investors because of the years they will have to wait to receive a distribution and because of the uncertainty of the amount. What each customer reasonably relied upon was that his investment was insured, up to \$500,000, against Madoff's dishonesty. SIPC's failure to promptly pay SIPC

insurance to the thousands of investors who were promised such insurance is a violation of SIPC's statutory duty.

It cannot be disputed that Congress intended for the trustee to promptly pay customer claims:

The committee . . . 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.**⁸

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 . . . 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.

While SIPC has never asserted that it could replace investors' securities within 48 hours (the time the FDIC takes to replace deposits), SIPC 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

⁸ (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)).

claims had been paid within a few months.⁹ 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."¹⁰

Madoff's records were not shoddy. On the contrary, the Trustee has been able to precisely reconstruct investors' net investment going back into the 1980's. Yet, he paid virtually no claims for the first five months of the case. Even after 22 months, he still has not determined over 2,000 claims

⁹ The *SJ Salmon* 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.

¹⁰ www.kiplinger.com/printstory.php?pid=12842

(while he and his law firm are being compensated at the rate of \$2.3 million per week).¹¹

II. NO DEFERENCE IS DUE TO THE SEC WHEN IT ASSERTS A POSITION WHICH IS INSUPPORTABLE UNDER THE STATUTE

SIPA is remedial legislation. As such it should be construed liberally to effect its purpose of protecting customers of SEC-regulated broker/dealers. *See In re First State Securities Corp.*, 34 B.R. 492, 496 (B.S.D. Fla 1983)(citing *Tcherepnin v. Knight*, 389 U.S. 332 (1967)); *In re Bell & Beckwith*, 1986 U.S. Dist. LEXIS 29804 at *5-6 (N.D. Ohio Jan. 31, 1986).

The SEC and SIPC have created an exception to SIPC's coverage which finds no basis in SIPA or its legislative history. There is no statutory exception in the definition of "net equity" for victims of any particular type of fraud or Ponzi scheme. Nor is there any provision of SIPA which warrants denial of SIPC insurance to customers whose statements reflect "fictitious trades." On the contrary, the legislative history reflects Congressional intent to insure customers of a broker who "never purchased" the securities reflected on the customer's statement.

¹¹ Ad. Pro. No. 08-01789 (BRL) Doc. #2943, #2967 (9/7/10 Objection to 4th fee applications of Irving H. Picard, Trustee and Baker & Hostetler LLP).

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 (1977); emphasis added.

Under these circumstances, the interpretation urged by the SEC and SIPC is entitled to no deference. As the Supreme Court held in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984):

If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.

See also Gen. Dynamics Land Sys. v. Cline, 540 U.S. 581, 600 (2004)(deference is only needed when “the devices of judicial construction have been tried and found to yield no clear sense of congressional intent”); *United States v. Gayle*, 342 F.3d 89, 92 (2d Cir. 2003)(“Statutory constructions begins with the plain text and, if that text is unambiguous, it usually ends there as well”); *NationsBank of North Carolina, N.A. v. Variable Annuity Ins. Co.*, 513 U.S. 251, 257 (1995)(quoting *Chevron U.S.A., Inc.*, 467 U.S. at 844)(“If the administrator's reading fills a gap or

defines a term in a way that is reasonable in light of the legislature's revealed design, . . . the administrator's judgment [is given] “controlling weight.”).

The exception for which the SEC and SIPC argue in this case is insupportable under SIPA’s definition of “net equity” and its prohibition against SIPC changing the definition of “net equity.” 15 U.S.C. § 78lll(11); § 78ccc(b)(4)(A). Exceptions to a statute’s coverage, such as that sought by the SEC and SIPC here “will be implied only where essential to prevent ‘absurd results’ or consequences obviously at variance with the policy of the enactment as a whole.” *United States v. Rutherford*, 442 U.S. 544, 552 (1979)(citing *Helvering v. Hammell*, 311 U.S. 504, 510-11 (1941); *Anderson v. Wilson*, 289 U.S. 20, 27, (1933); *TVA v. Hill*, 437 U.S. 153, 187-88 (1978); *Pacific River Council v. Thomas*, 30 F. 3d 1050, 1054 (9th Cir. 1994)(“when Congress’ intent is clear, the courts, not the agency are charged with the basic responsibility for statutory interpretation. A contrary agency interpretation is entitled to no deference.”). *See also*, *United States v. Key*, 397 U.S. 322, 324-25 (1970); *United States v. American Trucking Ass’ns.*, 310 U.S. 534, 543-44 (1940)).

Courts are prohibited from granting *Chevron* deference to agency interpretations that do not carry “the force of law”. *United States v. Mead Corp.*, 533 U.S. 218, 226-27 (2001). The “force of law” requirement has

been deemed satisfied in those cases where “Congress delegated authority to the agency generally to make rules carrying the force of law, and . . . the agency[’s] interpretation claiming deference was promulgated in the exercise of that authority.” *Estate of Landers v. Leavitt*, 545 F.3d 98, 105 (2d Cir. 2008) (quoting *Mead Corp.*, 533 U.S. at 226-27). Generally, interpretations that have qualified have been “regulations issued through notice and comment or adjudication, or in another format authorized by Congress for use in issuing ‘legislative’ rules”. *Estate of Landers*, 545 F.3d at 106 (quoting *Cnty. Health Ctr. v. Wilson-Coker*, 311 F.3d 132, 138 (2d Cir. 2002)) (inner citation omitted). Therefore, an interpretation issued through a non-legislative process is likely to be ineligible to receive *Chevron* deference. *Id.* at 107.

In re *New Times Securities Services, Inc.*, 371 F.3d 68 at 82 (2d Cir. 2004), this Court held that the SEC’s interpretation of SIPA was not entitled to *Chevron* deference because the SEC’s “informal opinion” proffered in its amicus brief lacked “the force of law” based on three factors: (1) the SEC’s failure to proffer its position in any prior rule or regulation; (2) the SEC’s failure to previously articulate such an interpretation in any form; and (3) the SEC’s admission that it expressed this position for the first time in the amicus brief. *Id.* at 81. Those same factors are equally present here.

The Trustee argues that the SEC's position is entitled to deference because the SEC took the same position in *New Times*. Trustee's Brief at 47. This argument is preposterous. The Trustee cites to the SEC's amicus brief in *New Times* where the SEC argued against allowing claims of investors with non-existent securities because the securities were not recorded on the debtor's books and records. However, the SEC argued, and the Court held, that investors with existent securities were entitled to claims in the amount of their last statement balance, even though the debtor never purchased the securities (and they were not recorded on the debtor's books and records). Thus, the controlling fact was not whether the securities purchases were accurately reflected on the debtor's books and records but rather, whether the customer had a legitimate expectation that his confirmations were accurate.

III. SIPC IS JUDICIALLY ESTOPPED FROM RENEGGING ON THE POSITION IT TOOK IN *NEW TIMES*

SIPC cursorily responds in a footnote (SIPC Brief at 26) to the argument that it is judicially estopped from taking a position contrary to the position it took in *New Times*. SIPC argues that its position in *New Times* is consistent with its position here. Yet, in *New Times*, SIPC took the precisely opposite position from the position it takes here:

[R]easonable and legitimate claimant expectations on the filing date are controlling even where inconsistent with transactional 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 transactional reality, not claimant expectations, were controlling, as this Court’s earlier opinion in this liquidation well illustrates.¹²

Similarly, in *New Times*, SIPC President, Stephen Harbeck, assured the bankruptcy court that customers whose statements showed real securities were entitled to the last statement value, even if the securities (never purchased) had tripled in value.

MR. HARBECK: And, if those positions triple, we will gladly give the people their securities positions.¹³

SIPC’s position in *New Times* cannot possibly be squared with the position that it and the Trustee have taken in this case. Thus, for the reasons set forth in the Peskin Appellants’ opening brief, SIPC and the Trustee are

¹² A150 (V.III), Brief of Appellant SIPC, 2005 U.S. 2d Cir. Briefs LEXIS 259, at *35-36 (Dec. 30, 2005), *New Times II* (citing *New Times*)(emphasis added).

¹³ July 28, 2000 Tr. at 37-38, *In re New Times Sec. Servs. Inc.* (B. E.D.N.Y. 2000) (emphasis added) A19(V. III).

judicially estopped from depriving Madoff customers of the replacement of the securities shown on their last statement, up to a value of \$500,000 as of November 30, 2008.

The Trustee argues that he is not judicially estopped because he “does not act under SIPC’s control.” That is certainly a very questionable proposition. The Trustee is, by law, a fiduciary of the customers. *See In re Adler, Coleman Clearing Corp.*, 1998 Bankr. LEXIS 1076 at *47 (B.S.D.N.Y. Aug. 25, 1998) (“The parties agree that a SIPA trustee owes a fiduciary duty to the customers and creditors of a liquidating broker dealer akin to the fiduciary duty a bankruptcy trustee owes a debtor’s estate and creditors”); *Germain v. The Connecticut National Bank*, 988 F. 2d 1323, 1330 n. 8 (2d Cir. 1993).

However, the practical reality is that the Trustee and his law firm are being compensated at the rate of \$2.3 million per week and that SIPC is unilaterally approving these fees without the bankruptcy court or the creditors having any ability to review the time records for reasonableness.¹⁴ It is virtually impossible, in this context, for the Trustee to be anything but a puppet of SIPC, as one court found with respect to another SIPC trustee:

¹⁴ Ad. Pro. No. 08-01789 (BRL) Doc. #2943, #2967(9/7/10 Objection to 4th fee applications of Irving H. Picard, Trustee and Baker & Hostetler LLP).

The basis for the creditors' motion to remove the trustee is that he "is no longer a disinterested party" in that "he continuously advances positions that are in the sole interest of SIPC" and "has acted in accordance with the wishes of SIPC regardless of the merits of SIPC's suggestions or its effect upon the estate."

I agree with movants that for all practical purposes the trustee has been a puppet for SIPC since the inception of this case. SIPC is a party to this case and has an interest completely divergent from that of almost all other creditors. [15 U.S.C. § 78eee\(d\)](#). These circumstances would require the immediate removal of a bankruptcy trustee under [11 U.S.C. § 324. 2 Collier on Bankruptcy \(15th ed.\) para. 324.02](#). Clearly the trustee would not be a "disinterested person" if the bankruptcy definition, [11 U.S.C. § 101\(13\)\(E\)](#), were controlling in this instance.

However, SIPC's counsel has argued convincingly that in a SIPA case the bankruptcy statute is not applicable and that the controlling statute contemplates and virtually assures that the trustee *will be* SIPC's puppet. Therefore, the fact that he is subject to SIPC's control may not be the basis for his removal.

In re First State Securities Corp., 39 B.R. 26, 27 (B.S.D. Fla. 1984).

As in the *First State Securities* case, the Trustee in this case has uniformly represented SIPC against the investors, advocating the denial of SIPC insurance for more than 50% of Madoff's victims and inexplicably delaying the meager payments of SIPC insurance to financially desperate investors. This has been devastating to tens of thousands of people because, even though there were less than 5,000 active accounts on November 30,

2008, many of the accounts contained the life savings of multiple (sometimes hundreds) of people.

Notwithstanding his legal obligations, the Trustee's position has been identical to SIPC's throughout this case and, for that reason, he should be estopped from seeking a result contrary to the position SIPC took in the *New Times* case.

The Trustee also argues that this case is different from *New Times* because "the appellants had not deposited sufficient funds to purchase the securities listed on their accounts statements; the funds used to 'purchase' the securities were the fictitious "profits" of earlier phony transactions." (Trustee's Brief at 36-37). However, SIPC President Harbeck himself assured the *New Times* bankruptcy court that SIPC would honor a customer's last statement even where a security had tripled in value. There is no rational distinction between a *New Times* customer whose investment tripled in value, and a Madoff customer whose investment tripled in value.

The Trustee argues that judicial estoppel applies only to factual issues, not legal ones and, therefore, it is inapplicable here. (Trustee's Brief at 49). However, the position taken by SIPC in *New Times* was a position based upon law and fact. The doctrine of promissory estoppel bars a party from "abandon[ing] . . . a claim to obtain a litigation advantage." *See HSBC*

Bank USA, N.A. v. Adelpia Communications Corp., 2009 U.S. Dist. LEXIS 10675, at *46 (W.D.N.Y. 2009)(quoting *Peralta v. Vasquez*, 467 F.3d 98, 105 (2d Cir. 2006)). By taking the position it took in *New Times*, SIPC avoided paying \$500,000 in SIPC insurance to all investors whose statements showed non-existent securities. Having achieved a substantial savings in that case, SIPC now wants the Court to hold, in this case, that it does not have to pay \$500,000 in SIPC insurance to customers whose statements showed existent securities. Neither SIPC nor the Trustee should be permitted to reverse positions at the expense of investors who reasonably relied upon the promise of SIPC insurance.

IV. THE TRUSTEE'S CLAWBACK EFFORTS ARE LIMITED BY 11 U.S.C. § 546(e)

The Trustee cannot justify, and has not attempted to justify, his netting out of deposits and withdrawals in a customer's account beyond the applicable statute of limitations period. Every single case the Trustee cites for the proposition that he can recover as a fraudulent transfer funds paid to a customer in excess of his net investment is a case decided under a non-SIPA liquidation Ponzi scheme case. (See Trustee's Brief at 38-39.) Yet, the Trustee (and the SEC) ignore *SEC v. Byers*, 637 F. Supp. 2d 166, 182 (S.D.N.Y. 2009), where Judge Chin held, with the support of the SEC, that it

would be “cruel” to sue investors to recover withdrawals in excess of net investment in a non-SIPA Ponzi scheme case.

There is no authority for a SIPA trustee suing an innocent investor to force him to disgorge payments from his broker. The reason for this is clear: it is utterly inconsistent with the purposes of SIPA to allow SIPC trustees to punish innocent investors by forcing them to disgorge distributions they received in the ordinary course of business and on which they paid taxes.

Similarly, with respect to the impact of §546(e), the Trustee acknowledges that its purpose was to “minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy involving those industries.” H.R. Rep. No. 97-420, at 1 (1982). Clearly, avoidance of all of the transfers made by Madoff to his customers would cause an enormous displacement. While the Trustee argues that §546(e) does not apply to the Madoff case because no securities were ever purchased, there is no requirement in §546(e) that the broker’s payment be made in satisfaction of securities actually purchased by the broker.

The Trustee argues that §546(e) does not reach “transactions that are actually fraudulent.” Trustee’s brief at 42. However, he has not cited a single case which supports that proposition. The Trustee cites *In re Grafton Partners LP*, 321 B.R. 527 (B.A.P. 9th Cir. 2005), decided prior to the 2006

amendment of §546(e), in which the issue was whether the withdrawal of capital from a limited liability company in a non-public, non-market transaction involving an illegally unregistered security is protected under §546(e). The court held that it was not because the transfer at issue could not be described as a “payment commonly used in the securities trade.” Clearly, this precedent is inapplicable to the present facts. Madoff’s payments to customers were ordinary course of business withdrawals of funds from customer accounts which reduced Madoff’s debt to the customer.

The Trustee cites *In the Matter of Max Wider*, 907 F.2d 570 (5th Cir. 1990), decided prior to the 2006 amendment of §546(e), where the court held that payments made by an unlicensed stockbroker were not protected under §546(e) because the debtor was not a “stockbroker” within the meaning of the statute and, hence, the Section 546(e) defense was not available. Clearly, this precedent is inapplicable to the present facts because Madoff was, indisputably, a stockbroker.

The Trustee cites *In re Adler, Coleman Clearing Corp.*, 263 B.R. 406 (S.D.N.Y. 2001), decided prior to the 2006 amendment of §546(e), where the trustee sought to avoid transfers between a broker and its clearing house. The court’s holding was that the transfers at issue were not “settlement payments” because they were not made in the ordinary course of the

settlement process. *Id.* at 481. The Trustee's reliance on that holding is misplaced because the payments at issue were made with the specific intent of increasing claimants' SIPC claims, as opposed to mere trading. *Id.* Here, on the contrary, the payments to investors were made in the ordinary course of business and reduced Madoff's indebtedness to each investor.

The Trustee cites *Enron Corp. v. JP Morgan Secs., Inc. (In re Enron Corp.)*, 2008 WL 281972, at *5) (S.D.N.Y. Jan. 25, 2008), where the district court merely affirmed the bankruptcy court's denial of a defendant's motion to dismiss a fraudulent transfer action because there were factual issues that needed to be determined as to whether the defendant was entitled to the protection of §546(e). The court noted, however, that the bankruptcy court's focus was on the propriety of the transactions as they related to **possible manipulation by defendants**. *Id.* at *4. Here, there is no allegation that the customers are guilty of any wrongdoing (except in the view of SIPC that the customers are chargeable with Madoff's fraud because they signed account opening agreements providing that Madoff was their agent for the purpose of purchasing securities).

The Trustee relies upon three Ponzi scheme cases for the proposition that transfers in furtherance of a Ponzi scheme are presumptively made with intent to defraud. The Trustee cites to *In re Manhattan Fund*, 397 B.R. 1, 10

(S.D.N.Y. 2007), and *In re Bayou Group, LLC*, 362 B.R. 624 (B.S.D.N.Y. 2007), which was reversed on appeal, *Freestone Low Volatility Partners, LP v. Bayou Accredited Fund, LLC*, 2010 U.S. Dist. LEXIS 99590 (S.D.N.Y. 9/17/10). Neither case was a SIPA liquidation. The *Bayou* case involved equity investors in Bayou, not investments in publicly-traded securities through an SEC-regulated broker/dealer where the investors had a debtor/creditor relationship with the broker. In *Manhattan Fund*, the fraudulent transfer action was not against a customer but against a prime broker. In both cases, the district courts reversed the bankruptcy court and held that the defendants were entitled to a trial on the issue of whether they had received the funds in good faith.

Similarly, the Trustee mistakenly relies upon *Drenis v. Haligiannis*, 452 F. Supp.2d 418 (S.D.N.Y. 2006). This case, also, was not a SIPA liquidation. Like *Manhattan Fund*, the defendants were equity investors in the debtor and received a return of their investment from the Ponzi schemer. The court's holding was simply that the complaint stated a claim for fraudulent intent because courts have generally held that a debtor's intent to hinder, delay, or defraud is presumed established by virtue of defendant's operation of a Ponzi scheme. Even the SEC acknowledges that non-SIPA Ponzi scheme precedent is inapplicable to a SIPA liquidation.

Clearly, under this Court's decision in *Sharp International Corp. v. State Street Bank and Trust Company*, 403 F. 3d 43 (2d Cir. 2005), the Trustee cannot recover fraudulent transfers where the payment from the debtor/broker to the customer satisfies a debt owed by the broker to the customer. Thus, consistent with *Sharp*, we urge the Court to hold, as a matter of law, that an innocent transferee of an account withdrawal from an SEC-regulated broker/dealer cannot be a fraudulent transfer. Using the analogy of the FDIC, that Congress repeatedly used when speaking of SIPC, it is inconceivable that a bank depositor would be sued by the FDIC, upon the liquidation of a bank, to disgorge withdrawals that the depositor took out of his account over a period of years.

V. INVESTORS HAVE CUSTOMER CLAIMS

SIPC argues that, to the extent the investors have claims beyond their net investments, they are general creditors in the Madoff bankruptcy, not customer claimants. However, SIPC has not cited a single case on point. All of the cases that SIPC cites for this proposition are cases where SIPC insurance clearly does not apply – cases involving investments that went bad or brokers who fraudulently induced investments, as opposed to brokers who stole their customers' money and didn't buy the securities. (SIPC Br. at 52). For example, in *In re Brentwood*, 925 F. 2d 325, 330 (9th Cir. 1991), the

investors did not have customer status because they did not entrust funds to the broker for the purpose of purchasing securities. On the contrary, they entrusted their funds to the issuing corporation to purchase its shares.

In *SIPC v. Associates Underwriters, Inc.*, 423 F. Supp. 168 (D. Utah 1975), the investors were not “customers” because they did not purchase specific securities; they purchased contracts for certain types of investments.

In *In re Klein, Maus & Shire, Inc.*, 301 B.R. 418-20 (B.S.D.N.Y. 2003), the investors were not customers under SIPA because they alleged that the broker made unauthorized trades in their accounts, yet they never objected to the trades, as required by their account agreements.

In *In re MV Securities, Inc.*, 48 B.R. 156, 160 (B.S.D.N.Y. 1985), the investor was not a customer under SIPA because her claim was that the broker had given her bad advice.

In *In re Bell & Beckwith*, 124 B.R. 35 (B.N.D. Ohio 1990), the court held that certain investors were not “customers” under SIPA because they were asserting a claim for fraudulent misrepresentation against the broker.

CONCLUSION

For the reasons stated herein, in the Peskin Appellants’ opening brief, and in the briefs submitted by the other appellants, we respectfully request that this Court reverse the Decision and Order and remand with instructions

for entry of an order requiring the Trustee to replace securities at the selection of each investor, up to a value of \$500,000 based upon each investor's last statement (as required by 15 U.S.C. §78fff(3)(c)(1)) or, at the election of each investor, to pay up to \$500,000 plus New York statutory interest of 9% from February 11, 2009, based upon each investor's November 30, 2008 statement.

Dated: New York, New York
October 12, 2010

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**CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME
LIMITATION, TYPEFACE REQUIREMENTS AND TYPE STYLE
REQUIREMENTS**

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because it contains 6926 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2003 in size 14 Times New Roman font.

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**UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT**

In re:

BERNARD L. MADOFF
INVESTMENTS SECURITIES, LLC.

Debtor.

CERTIFICATE OF SERVICE

10-2378

I, Lourdes Blanco, hereby certify that on October 12, 2010 I caused a copy of the Reply Brief for Appellants Diane and Roger Peskin, Maureen Ebel and other customers as listed on the inside cover of Appellants' Reply Brief to be filed with the Court electronically and by hand and served upon the parties in this action who receive electronic service through CM/ECF, and served upon the parties listed below, as follows:

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