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Another Madoff Masquerade?: Questioning "Securities Fraud" in the Crime and Its Cleanup

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ANOTHER MADOFF MASQUERADE?: QUESTIONING "SECURITIES FRAUD" IN THE CRIME AND ITS CLEANUP

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ABSTRACT

In December 2008, broker-dealer CEO Bernard Madoff confessed to a massive Ponzi scheme. Days later, he was charged by the Securities and Exchange Commission and the United States Attorney for, among other things, securities fraud. The theory of prosecution proceeded on the premise that Madoff's illicit investment advisory activities (which stemmed from his reputation in the industry) operated wholly apart from his broker-dealer activities. Subsequently, both the SEC and FINRA (the industry's largest self-regulator) concluded studies affirming that no securities transactions took place at the broker-dealer—for years, the man with the famous investment firm and his employees had simply spent the cash. Nonetheless, in remedy, the Securities Investor Protection Corporation commenced the process of marshalling all of Madoff's broker-dealer assets for reimbursement of his Ponzi scheme victims.

Accordingly, this Article examines two crucial, related determinations made in the aftermath of the Madoff scandal: 1) the decision to charge a Ponzi scheme as a violation of SEC Rule 10b-5, and 2) the decision to reimburse certain investors in the Ponzi scheme with SIPC funds. Those determinations are at best debatable given the "pooled fund" nature of the fraud, the complete absence of investment activity, and the near-complete absence of brokerage-house custody of most of the fraud's assets.

Specifically, while case law from certain circuits supports the notion that, under certain circumstances, a non-purchase of a security can equate with a purchase/sale for purposes of Rule 10b-5, such an expansive reading of the

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anti-fraud prohibition seems to greatly expand upon the Supreme Court's reasoning whence last taking up the cause. And while SIPC reimbursement under the Securities Investor Protection Act is somewhat discretionary, the decision to reimburse Madoff investors and not those of a contemporaneous billion dollar fraud conducted by another brokerage house chief seems dangerously incongruent.

In conclusion, this Article posits that future SEC rulemaking should remove all uncertainty surrounding the application of Rule 10b-5 to Ponzi schemes driven by the promoter's reputation. In turn, such certainty (along with reforms to the investment advisory custodial process) should solidify both expectations and remedies when there is a lack of actual investment. In short, with some tweaking, the rules can better support the decision to reimburse those unfortunate investors who entrust funds with industry "players" who are later revealed to be to be merely market mascots.

INTRODUCTION

Imagine you are at a professional baseball game. The stadium is filled with 40,000 fans. Making the rounds is Mr. Bases, the trustworthy team mascot for the past forty years. Your neighboring fans are universally extolling Mr. Bases' devotion to his followers—a passion so deep that he shares business opportunities with them. You hear that he personally runs, among other things, a hedge fund and a banana warehouse, and that his "investors" make returns tripling those in the stock market. All your fellow fans are rushing to open their wallets, and so do you.

You hand a check to Mr. Bases and take comfort in knowing the stadium's address. From time to time you receive "statements" in the mail attesting to your increasing investment, but, for the most part, you rely on the good name of Mr. Bases.

Years later, you learn that there was no hedge fund and that all your money is gone. Not to worry—the County Sheriff has arrested Mr. Bases on charges of "securities fraud." Further, a decades-old federal law provides reimbursement if you just go along with the theory that you were a banana company customer. Change the locale to a wedding, the mascot to Bernie Madoff, the banana company to a brokerage, and the sheriff to the Securities and Exchange Commission and you may have a more meaningful picture of the Madoff scandal than has been presented to date.

* * * *

In June 2009, Bernard Madoff was sentenced to 150 years in prison for his confessed securities fraud.[1] Linked to losses exceeding $30 billion, the extreme sentence was largely non-controversial.[2] In the years since his theft came to light, a New York City lawyer acting as court-appointed, bankruptcy Trustee[3] has overseen the collection of remaining Madoff assets and their re-

1. Diana B. Henriques, *Madoff, Apologizing, is Given 150 Years*, N.Y. TIMES, June 30, 2009, at A1.

2. *See* CAPITALISM: A LOVE STORY (Overture Films 2009) (showing scenes of angry protesters, including a woman holding a sign stating, "Wall Street Madoff With My Tax $$$"); *see also* CHARLES GASPARINO, THE SELLOUT: HOW THREE DECADES OF WALL STREET GREED AND GOVERNMENT MISMANAGEMENT DESTROYED THE GLOBAL FINANCIAL SYSTEM 199 (2009) (noting that government ineptitude caused investigators to miss several scandals including the "$50 billion Ponzi scheme perpetrated by Bernard Madoff, who was examined by the SEC nine times and each time given a clean bill of health").

3. Namely, Irving Picard, Esq. (the "Trustee") of the New York law firm of Baker and Hostetler, LLP. Diana B. Henriques, *Madoff Says from Prison that Banks 'Had to Know'*, N.Y. TIMES, Feb. 16, 2011, at A1.

distribution among Madoff victims—a dollar amount in the billions to date.[4] Over 15,000 claims for reimbursement under the Securities Investor Protection Act of 1970 ("SIPA")[5] have been filed.[6] The related lawsuits—against Madoff, alleged co-conspirators, and others—are expected to last for years.[7]

Of the varied, strained premises employed to quickly lock up Mr. Madoff (who initially refused to speak to authorities and still has provided sparing details on his fraud[8]), the most glaring is the government's adoption of a split empire scheme that portrays Madoff's brokerage operations as half-hell and half-purgatory. Specifically, the Securities and Exchange Commission ("SEC" or "Commission") complaint of December 11, 2008—a mere twenty-four paragraphs describing a multi-decade, multi-billion dollar fraud—asserted the following:

> 15. Madoff conducts certain investment advisory business for clients that is separate from the [brokerage] proprietary trading and market making activities.
>
> 16. Madoff ran his investment adviser business from a separate floor in the New York offices of [his brokerage].[9]

Later, the self-study by the industry's largest regulator went further in detailing the disconnect between Madoff's operations when it concluded that the investment advisory business "consisted, at bottom, of a bank account and fictitious customer accounts that were not reflected on the broker-dealer's

4. *See* Richard Sandomir & Serge F. Kovaleski, *Mets Owners Rebut Charges In Madoff Suit*, N.Y. TIMES, Mar. 21, 2011, at A1 (referencing the successes of the Trustee in recovering "roughly $10 billion for Madoff's victims" since 2008).

5. Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa et seq. (2006).

6. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 124 (Bankr. S.D.N.Y. 2010).

7. *See* Henriques, *supra* note 3 (noting that the Trustee has filed hundreds of lawsuits seeking billions of dollars in damages).

8. *See id.* (describing Madoff's statement that he had helped prosecutors "to help recover assets only, I refused to help provide them with criminal evidence").

9. Complaint at 5, SEC v. Madoff, No. 08 Civ. 10791, 2009 WL 980288 (S.D.N.Y. Apr. 10, 2009); *see also* SEC v. Cohmad Secs. Corp., 09 Civ. 5680, 2010 WL 363844, at *1–3, *6 (S.D.N.Y. Feb. 2, 2010) (dismissing securities fraud charges against a registered broker-dealer compensated to introduce clients to Madoff and stating that "[t]he Cohns worked in Cohmad's New York office on the 18th and 19th floors of B[L]MIS's New York premises, from which B[L]MIS operated legitimate market-making and proprietary trading businesses. B[L]MIS's fraudulent investment advisory business was on the 17th floor."). In 2009, Madoff settled the SEC case against him by agreeing to a Partial Judgment on Consent Imposing Permanent Injunction and Continuing Other Relief. The effectuating Order cited only Madoff's admission to "a giant Ponzi scheme" numbering in the billions of dollars and revealed by his "advisory client redemption requests." Bernard L. Madoff, Exchange Act Release No. 60,118, Investment Advisers Act Release No. 2892, 96 SEC Docket 337 (June 16, 2009).

books."[10] Likewise, the SEC's own contemporaneous study summarily concluded that not a trade related to the investment business was placed at the broker-dealer.[11]

Nonetheless, Madoff's nominally distinct business lines were conjoined, for the banana business/hedge fund theory truly served several needs. To wit, victims of a naked con were clothed in securities industry reimbursements, while the con's perpetrator was incarcerated with little effort or paperwork. Meanwhile Madoff, unwilling to disclose details and co-defendants, at his criminal plea hearing in March 2009 played his role to perfection, allocuting that he "operated a Ponzi scheme through the investment advisory side" of his broker-dealer.[12]

Such a simplistic characterization of a dangerously global enterprise allowed the SEC to quickly punish an admitted fraudster based upon his "advisory business" (i.e., his hedge fund, which was patently riddled with fraud) without reference to the brokerage business (i.e., his banana warehouse, which consistently provided inventory to some of the largest firms on Wall Street). Going forward, unless these expedient theories of 1) a clearly divided con game, and 2) its kingpin consistently acting as a stockbroker to his victims are both acknowledged and addressed, stock market participants remain dependent upon unclear prohibitions and unpredictable government largesse. Securities law, which is administered by a seventy year old legal framework, was expressly designed to avoid such uncertainties.[13] It bears noting that, even

10. FINANCIAL INDUSTRY REGULATORY AUTHORITY, REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES 57, 64 (2009), *available at* http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf [hereinafter FINRA REPORT] (stating elsewhere "Although FINRA's examinations did present the opportunities discussed above, its examination program did not exploit them because it was not designed to ferret out a sophisticated fraud, like Madoff's Ponzi scheme, that was kept almost entirely 'off the books' of a member firm.").

11. OFFICE OF INVESTIGATIONS, U.S. SECS. & EXCH. COMM'N, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME 40 (2009) [hereinafter OIG REPORT], *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf ("When Madoff's Ponzi scheme finally collapsed in 2008, an SEC Enforcement attorney testified that it took only 'a few days' and 'a phone call . . . to DTC' to confirm that Madoff had not placed any trades with his investors' funds.").

12. Plea Allocution of Bernard L. Madoff at 1, United States v. Madoff, 626 F. Supp. 2d 420 (S.D.N.Y. 2009) (No. 09 Crim. 213 (DC)).

13. *See, e.g.*, Legal Information Institute, *Securities Law: An Overview*, CORNELL UNIVERSITY LAW SCHOOL (Aug. 19, 2010, 5:24 PM), http://www.law.cornell.edu/wex/Securities ("Securities laws and regulations aim at ensuring that investors receive accurate and necessary information regarding the type and value of the interest under consideration for purchase.").

in the wake of the most horrendous and far-flung Ponzi scheme in history, courts do not always rush to bless labored theories of liability.[14]

Accordingly, this Article seeks to examine the legal underpinnings for the confessions by Bernard Madoff as well as the theory by which his "victims" are receiving reimbursements through a dedicated insurance fund.[15] While the Madoff disaster is undoubtedly a fluid topic, this Article nonetheless relies on statutes, case law, pleadings, hearings, government filings, the academic and popular press, and regulatory studies to hopefully provide timely insights into the exact rationales that placed its progenitor in prison and that continue to fuel the partial recovery of the lost assets. To that end, Part I provides a detailed timeline to acquaint the reader with the most relevant facts in the nation's ongoing ordeal in remedying its worst Ponzi scheme. Part II introduces the elements of the SEC's famed Rule 10b-5, while Part III discusses the traditional application of the fraud prohibition to Ponzi schemes. Part IV explains the relevance of the Securities Investor Protection Act and its effectuating entity, the Securities Investor Protection Corporation ("SIPC").[16] The Article concludes with suggestions regarding SEC rulemaking that would quicken the application of the law defining securities fraud to Ponzi schemes in the future. Overall, the Article seeks to explore the granular legal justifications for the policy choices made in response to the disclosure of the world's largest financial fraud, as well as the attendant judicial criticism thereof.

I. DETAILED TIMELINE

The tale of Bernard Madoff and the law begins and ends with the toppled kingpin's reputation: Madoff's ascent in the securities business was due to his

14. *See, e.g.*, *Ponzi Schemer's Sentence Might Be based on 'Nonexistent Offense,' Fifth Circuit Finds*, 42 Sec. Reg. & L. Rep. (BNA) 1590, 1590 (Aug. 23, 2010) (describing *Garland v. Roy*, 615 F.3d 391 (5th Cir. 2010), in which Judge James L. Dennis remanded for further proceedings the money laundering convictions of the "[p]yramid scheme mastermind" Gene Irving Garland because figures were based on "'profits' instead of 'gross receipts'"); *see also* sources cited *infra* note 50.

15. This Article does not seek to plumb the basis for private actions against the growing number of parties alleged to have assisted Madoff with his long-lived scheme. For one article that has discussed this particular area, see Melissa C. Nunziato, Comment, *Aiding and Abetting, A Madoff Family Affair: Why Secondary Actors Should Be Held Accountable for Securities Fraud Through the Restoration of Private Right of Action for Aiding and Abetting Liability Under the Federal Securities Laws*, 73 ALB. L. REV. 603 (2010).

16. SIPC is a private, non-profit membership corporation that insures the securities and cash in broker-dealer customer accounts against the failure of those firms. THOMAS LEE HAZEN & DAVID L. RATNER, SECURITIES REGULATION IN A NUTSHELL 204 (9th ed. 2006). Cash and securities are protected up to a maximum of $500,000. *Id.* at 206. However, "SIPC does not protect . . . against losses caused by a decline in the market value of . . . securities." *Securities Investor Protection Corporation (SIPC)*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/sipc.htm (last visited Nov. 19, 2011).

popularized bravado; his resulting celebrated operation of a successful broker-dealer attracted unfathomable amounts of investments (and has led to literally incalculable amounts of customer reimbursements). In between, a trusted Wall Street figure perpetrated a scam more befitting a carnival hawker than a wizened corporate CEO.[17]

A. Broker-Dealer History

It is axiomatic that Bernard Madoff had been a trusted titan of Wall Street. Madoff was the quintessential self-made man, starting a registered securities broker-dealer in 1960 with money he saved from odd jobs and rising to become the chairman of the NASDAQ market by 1990.[18] Along the way, he also cultivated notable relationships with key market regulators.[19]

His first publicized successes came from providing an alternative to the traditional, peopled market dominated by the New York Stock Exchange ("NYSE"). Madoff's chosen market—the NASDAQ, born in 1971[20]—was primed to start a revolution. Specifically, while longer established firms were content to trade via the exchange floor, Madoff's firm relied on the new computer-driven market, subsequently developing a robust roster of clients via the questionable (but legal) practice known as distributing "payment for order flow."[21] Cyber-trading and its champion so grew in clout as to rival the NYSE Chairman in influence upon the London Stock Exchange when the latter was

17. Diana B. Henriques, *Madoff Scheme Kept Rippling Outward, Crossing Borders*, N.Y. TIMES, Dec. 20, 2008, at A1 (quoting a Beijing businessman as saying that Madoff's funds were pitched "to anyone who would listen").

18. *See id.* (explaining how, by the year 2000, Madoff's firm was the largest NASDAQ market maker, and Madoff had become a member of the prestigious Securities Industry Association (now titled "SIFMA")); *see also* Julie Creswell & Landon Thomas Jr., *The Talented Mr. Madoff*, N.Y. TIMES, Jan. 25, 2009, at BU1 (stating that in the 1960s, Madoff used $5000 saved from a lifeguarding job and a sprinkler business and "joined the ranks of Wall Street").

19. *See* Creswell & Thomas, *supra* note 18 ("Arthur Levitt Jr., who served as S.E.C. chairman from 1993 to 2001, has acknowledged that he occasionally turned to Mr. Madoff for advice about how the market functioned."); *see also* OIG REPORT, *supra* note 11, at 15 (noting a comment by a senior SEC examiner to a junior examiner that Madoff was "a very well-connected, powerful person"); FINRA REPORT *supra* note 10, at 46 n.53 ("Madoff and some members of his family became well-known members of the financial community. Madoff served as Chairman of NASDAQ in the early 1990s. His brother, Peter Madoff, served on the NASD Board, including as Vice Chair, as well as various committees.").

20. *See* Matt Phillips, *Nasdaq Bids for Last Laugh in Long Rivalry*, WALL ST. J., Apr. 2–3, 2011, at A4 (noting that the Nasdaq market exceeded the NYSE daily trading volume seven times in 1983).

21. "Payment for order flow" is the compensation and benefits paid to brokers in exchange for directing investors' orders to securities markets. The brokerage receives a small payment, usually one to three cents, for each order the broker directs to the securities market. Allen Ferrell, *A Proposal for Solving the "Payment for Order Flow" Problem*, 74 S. CAL. L. REV. 1027, 1028–29 (2001).

contemplating eradicating its storied trading floor in the mid-1980s.[22] As a biographer of NYSE history chronicled:

> [Then NYSE Chairman John] Phelan traveled to London to make the case for the status quo. He was opposed by the chairman of the Nasdaq, Bernie Madoff. Madoff had built a career out of attacking the NYSE. Phelan argued that a centralized market of buyers and sellers was needed so big brokers could take advantage of investors' positions. . . . Madoff said just the opposite: that fair prices are set by multiple players interacting continuously, and investors are smart enough to know how to hide their hands. The New York Stock Exchange, he explained, was a relic . . . . In 1986, the London Stock Exchange made it official: it was implementing more computers on its floor, eliminating the face-to-face auction system that had prevailed for most of its history.[23]

After the world markets' begrudging acceptance of computerization, Madoff furthered the charge to provide alternatives to traditional exchange-based trading.[24] This "third market" activity was later described by an NYSE official as emboldening Madoff to subsequently venture into outright fraud.[25] In the 1990s, while continuing to meet Wall Street's demand for inventory through a highly successful broker-dealer business,[26] Madoff privately grew a behemoth side business: "managing" investments for thousands of customers (hereinafter "Investors").[27] In hindsight, it is posited that the monies solicited from the Investors helped Bernard L. Madoff Investment Securities

22. CHARLES GASPARINO, KING OF THE CLUB: RICHARD GRASSO AND THE SURVIVAL OF THE NEW YORK STOCK EXCHANGE 56–57 (2007).

23. *Id.* at 57.

24. *See Fresh Air: Examining Bernie Madoff, 'The Wizard of Lies'* (NPR radio broadcast Apr. 26, 2011), *available at* http://www.npr.org/2011/04/26/135706926/examining-bernie-madoff-the-wizard-of-lies (interviewing Diana Henriques, author of *The Wizard of Lies: Bernie Madoff and the Death of Truth*, who describes Madoff as "a key figure in the evolution of the American stock market in the 1990s, when automation and computerization—and even more importantly, globalization—began to reshape the American stock market").

25. Ray Pellechia, *'Payment for Order Flow': Madoff's Earlier Days*, SEEKING ALPHA (Dec. 30, 2008), http://www.seekingalpha.com/article/112537-payment-for-order-flow-madoff-s-earlier-days ("[P]rospective investors unfortunately took the leadership roles of Bernard Madoff and his family at Nasdaq and NASD as qualifying credentials for the firm as an investment manager, not warning signs or conflicts of interest that needed to be vigorously overseen.").

26. BLMIS was said to have employed "hundreds of traders" and to have forged trading partnerships with Merrill Lynch, Goldman Sachs, and other large brokerages. Diana B. Henriques & Zachery Kouwe, *U.S. Arrests A Top Trader in Vast Fraud*, N.Y. TIMES, Dec. 12, 2008, at A1.

27. *See* Floyd Norris, *A Blank Check for Cleaning Up Madoff's Mess*, N.Y. TIMES, Feb. 25, 2011, at B1 ("At the end, Mr. Madoff's customers had combined fictional positive balances of $73.5 billion. . . . Mr. Madoff had allowed some customers to borrow more than $8 billion from the funds at low cost.").

("BLMIS") appear consistently prosperous to counterparty broker-dealers, although some entities certainly had their doubts.[28]

B. The Investment Advisory Business

The doubts about a broker-dealer that appeared to be recession-proof stemmed from an advisory business divorced from performance. The sales tactics for this advisory business[29] were shamefully direct, often involving puffery and sales tactics more befitting a boiler room than an investment fund run by the former Chair of the world's foremost cyber-market.[30] In sum, the "pitch" sometimes involved foreign nations, often employed middlemen, and usually played upon a false sense of urgency to join a prosperous enterprise.[31] As an early account described it:

> Initially, he tapped local money pulled in from country clubs and charity dinners, where investors sought him out to casually plead with him to manage their savings so they could start reaping the steady, solid returns their envied friends were getting. . . . A Swiss hedge fund manager . . . still remembers the pitch he got a few years ago from a salesman in Geneva. "He told me the fund was closed, that it was something I couldn't buy . . . . But he told me he might have a way to get me in. It was weird."[32]

Numerous other accounts relate stories of friends of friends, relatives, and aggressive acquaintances; a common thread is an aura of prosperity lent by an industry insider cemented by a go-between.[33]

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28. *Id.* ("From 2000 through 2007, the [BLMIS] trading business reported profits of $324 million. SIPC, having gone through the bank records, says almost exactly twice that was stolen from investors in the Ponzi scheme and diverted to the brokerage business.").

29. The exact number of "funds" managed by Madoff is unclear. *See* Henriques & Kouwe, *supra* note 26 (estimating "more than two dozen funds overseeing $17 billion").

30. *See infra* note 32 and accompanying text.

31. *See infra* note 32 and accompanying text.

32. Henriques, *supra* note 17. *See also* THE CLUB NO ONE WANTED TO JOIN–MADOFF VICTIMS IN THEIR OWN WORDS 28 (Alexandra Roth comp., Erin E. Arvedlund ed., 2010) [hereinafter THE CLUB] ("I quizzed my father about what he knew about Madoff's investments, and he told me that years earlier he attempted to ask Bernie about his investment strategies. At that time, Bernie simply told them that if he didn't trust him, he could just pull out of the investment entirely. There were plenty of investors clawing to invest with Bernie!").

33. THE CLUB, *supra* note 32, at 90 ("When we would go to the family dinners with my aunt and uncle and cousins, the family talked about this money manager who was conservative, smart, and head of the industry, market maker and a real great guy. I later learned in life that this man's name was Madoff."); *id.* at 64 ("We opened our account with Madoff by going to one of his feeder representative's offices and getting on a conference call with Bernard Madoff. The feeder rep had previously discussed everything on the phone with my mom and uncle . . . ."); *id.* at 57 ("My mom spoke to Annette Bongiorno, Madoff's secretary, after her account was set up and a few months later Annette suggested we create a partnership.").

C. Where Was the Money?

While initial public reports centered on Madoff's professed failed options strategy,[34] this turned out to be a long-running ruse, as no Investor trades in options were ever actually placed.[35] Additionally, while communications generated by Madoff's accomplices openly and consistently advertised BLMIS' role, relatively little Investor money resided at BLMIS, as the actual housing of the Investor funds was often with commercial banks.[36] For example, in February 2010, the SEC charged Madoff's Director of Operations with violations of various securities law provisions (including Rule 10b-5) based upon his alleged role in doctoring financials and lying to investors.[37] That SEC Complaint details the monies taken into BLMIS as follows:

> The Ponzi Scheme Accounts included, inter alia, the following accounts:
>
> a. A bank account (the "Main Ponzi Scheme Account") maintained at a bank in New York, New York ("Bank A") that B[L]MIS used, among other things, to receive investor deposits and pay investor redemptions. Billions of dollars of investor funds were deposited into the Main Ponzi Scheme Account while Madoff's Ponzi scheme was underway.
>
> b. A separate account maintained at Bank A that B[L]MIS used to deposit cash or securities that could be used as collateral to secure bank loans, and to hold custody of treasury bills that B[L]MIS purchased with investor funds from the Main Ponzi Scheme Account.
>
> c. At least four brokerage accounts (the "Brokerage Accounts") that were held in the name of Bernard L. Madoff. B[L]MIS used investor funds from other Ponzi Scheme Accounts to fund the Brokerage Accounts.[38]

Separately, FINRA's study concluded as follows:

> Madoff went to considerable lengths to conceal his investment advisory scheme and keep it separate from the broker-dealer business of the firm. For example, the market making and proprietary trading side of the Madoff firm used bank accounts held at the Bank of New York. These accounts were reflected in the firm's books and records, the FOCUS reports that it filed with FINRA, and the audited financial statements that it filed with both FINRA and

34. *See, e.g.*, Steven M. Sears, *Assessing Bernie Madoff's Strategy*, BARRON'S THE STRIKING PRICE BLOG (Dec. 15, 2008), http://online.barrons.com/article/SB122931051061206043.html.

35. *See* FINRA REPORT, *supra* note 10, at 47 ("According to the SEC, the Madoff firm never executed a single securities trade in the course of the investment advisory business . . . .").

36. *See infra* notes 178–85.

37. *See* SEC Charges Madoff's Director of Operations With Falsifying Accounting Records and Siphoning Investor Funds, SEC Litigation Release No. 21424, 97 SEC Docket 2979 (Feb. 25, 2010) (describing the Complaint against Daniel Bonventre, which also accuses the former BLMIS official of $1.9 million in unjust enrichment).

38. Complaint at 8–9, SEC v. Bonventre, No. 10-CV-1576 (S.D.N.Y. Feb. 25, 2010).

> the SEC. The investment advisory business, on the other hand, used accounts at JP Morgan Chase, which were not reflected in regulatory filings made by the Madoff firm in connection with its broker-dealer operations. Similarly, the fictitious trading activity and securities positions that Madoff reported to his investment advisory clients did not appear in the records of the firm's broker-dealer business.[39]

Thus, as confirmed by the industry's largest self-regulator, Investor money was maintained at banks, while the brokerage accounts at BLMIS (although represented in fictitious account statements as both healthy and active) were held in Madoff's name and dedicated to unrelated personal or firm proprietary activity.[40] Yet, ironically, it would be the stock market downturn that would bring an end to the accounts with no stock market trades.

D. The Revelation

In early December 2008, with the world economy in an ever-heightening state of shock, Madoff's proverbial house of cards tumbled down. Simply put, Investor demands for redemptions outpaced assets, and the Ponzi scheme could not continue.[41] Madoff was arrested; his sons, who served as lieutenants to various of his enterprises, claimed ignorance of the fraud.[42] After sharing little information with authorities, Madoff pleaded guilty to securities fraud and other offenses on March 12, 2009.[43]

An array of varied criminal charges ensued. In August 2009, Madoff's CFO pleaded guilty to conspiracy to various offenses, including securities fraud and money laundering.[44] In November, Madoff's auditor—a sole practitioner—pleaded guilty to securities fraud while stating that he was unaware of any Ponzi scheme.[45] That same month, two computer

39. FINRA REPORT, *supra* note 10, at 47 (footnote omitted). The FOCUS Report ("Financial Operational Combined Uniform Single Report") is a monthly report required of all firms registered with self regulatory organizations such as FINRA and the New York Stock Exchange. The report is touted as providing "a complete, detailed view of a firm's financial and operational conditions." ROY S. FREEDMAN, INTRODUCTION TO FINANCIAL TECHNOLOGY 289 (2006).

40. *See* OIG REPORT, *supra* note 11, at 20 n.4 ("The $18 to $24 million in positions [detailed on Depository Trust Company records] were associated with the firm's own account.").

41. *See* Norris, *supra* note 27.

42. Steve Eder & Mary Pilon, *A Madoff Son Looks Forward*, WALL ST. J., Dec. 20, 2010, at C1.

43. Linda Wertheimer & Jim Zarroli, *After Guilty Plea, Madoff Sentencing Set for June 16th*, NPR (Mar. 12, 2009), http://www.npr.org/templates/story/story.php?storyId=101796878.

44. *Ex-Madoff CFO Jailed After Plea*, ORLANDO SENTINEL, Aug. 12, 2009, at B6.

45. Larry Neumeister, *Madoff Auditor: I Wasn't Aware of Bernie's Fraud*, HUFFINGTON POST (Nov. 3, 2009, 2:11 PM), http://www.huffingtonpost.com/2009/11/03/david-friehling-madoffs-a_n_343946.html.

programmers were charged by the U.S. Attorney's Office with facilitating Madoff's crimes.[46]

Also in 2009, the SEC Office of Inspector General released its official report (hereinafter "OIG Report") on the "failures" of the agency to detect or prevent the Madoff fiasco.[47] The OIG Report revealed a surreal tale of anonymous tips, unheeded red flags and corroboration never sought, all commencing with a 1992 complaint about Madoff's "unregistered investment company."[48] Other studies similarly offered creative names for Madoff's investment activities.[49] But regardless of its exact nature, it became clear that the long-running scheme had received ongoing assistance from Madoff's co-workers. The related civil litigation has, at times been unpredictable—indeed, aggrieved third parties asserting Rule 10b-5 claims against alleged aiders and abettors have seen their lawsuits outright dismissed.[50] Nevertheless, by mid-2010, various courts had blessed plaintiffs' theories that some alleged "feeder funds" (and some related third parties) involved in the Madoff scheme should stand trial for damages.[51] Better grounded yet was the notion that, while some

46. Josh Duboff, *Two Computer Programmers Indicted for Role in Madoff Scheme*, N.Y. MAG. (Mar. 18, 2010, 12:26 AM), http://nymag.com/daily/intel/2010/03/two_computer_programmers_indic.html. The three charges were "conspiracy, falsifying the books and records of a broker-dealer, and falsifying the books and records of an investment adviser." *Id.* In subsequent months an arbitrage securities trader for BLMIS, David Kugel, was also charged with securities fraud. Complaint at 3, SEC v. Kugel, No. 11 Civ. 8434 (S.D.N.Y. Nov. 21, 2011), *available at* http://sec.gov/litigation/complaints/2011/comp22166.pdf. Approximately two weeks after the filing of the Kugel Complaint, the defendant pleaded guilty to criminal charges (including conspiracy and bank fraud) and also settled the SEC charges. *Ex-Madoff Trader Pleads Guilty Over Role in Scam; Settles SEC Action*, 43 Sec. Reg. & L. Rep. (BNA) 2420 (Dec. 5, 2011).

47. *See* OIG REPORT, *supra* note 11, at 368. It should be noted that the SEC investigation was compelled to confront in part the suspicion that a Commission Assistant Director's "relationship" with Madoff's niece "influenced the conduct of the SEC examinations of Madoff and his firm." *Id.* at 20. While highly critical of the SEC's investigative failures, the Office of Inspector General found that the relationship did not influence decision-making. *Id.*

48. *Id.* at 21–22.

49. *See* FINRA REPORT, *supra* note 10, at 57 (referring to the Madoff activities in issue as "the investment advisory business"); OIG REPORT, *supra* note 11, at 5 (referring to the same business as "hedge fund operations").

50. *See In re* J.P. Jeanneret Assocs., 769 F. Supp. 2d 340, 346 (S.D.N.Y. 2011) (dismissing claims against auditors and other parties); S. Cherry St., LLC v. Hennesee Grp. LLC, 573 F.3d 98, 99–100 (2d Cir. 2009) (dismissing a Rule 10b-5 claim by an investor against a feeder hedge fund alleged to have been aware of its involvement with a Ponzi scheme); *see also SLUSA Topples Claims by Investors In Funds That Channeled Money to Madoff*, 43 Sec. Reg. & L. Rep. (BNA) 874, 874–75 (Apr. 25, 2011) (finding that, in *In re Kingate Management Ltd. Litigation*, No. 09-Civ-5386, 2011 WL 1362106 (S.D.N.Y. Mar. 30, 2011), the defendants' alleged misstatements satisfied Rule 10b-5 for purposes of applying the federal statute designed to facilitate removal and dismissal of common law claims).

51. *See Claims Against Madoff Feeder Funds, Gatekeepers May Proceed, Court Concludes*, 42 Sec. Reg. & L. Rep. (BNA) 1587, 1587 (Aug. 23, 2010) (describing *Anwar v. Fairfield*

investors deserved to be recompensed, others must have known that a game was afoot.[52] In late 2010, more accomplices were identified and additional details on the fraud were provided by SEC civil charges against two BLMIS employees who were alleged to have helped mislead auditors or investors through the preparation of "false books and records" and participation in "telephone conversations" concerning trades and positions that never existed.[53] Likewise, criminal charges—and parallel SEC actions—were brought against two BLMIS officers who had allegedly "purported to execute paper, as opposed to actual trades" for Madoff investors.[54] Ultimately, the fraud was so apparent and readily conceded by so many that the press focused primarily on the government's inability to detect it.[55] Subsequent scrutiny failed to disclose a scheme that was either unknowable or unknown.

E. The Autopsy

The regulatory filings submitted by Madoff's entities during the fraud revealed little about the dual empire theory later clung to by regulator and defendant alike. Specifically, the Form BDs[56] filed by BLMIS exposed the firm's activities only as Madoff chose to proclaim them. Generally, section 12 of a Form BD requires the registrant to disclose all "types of business engaged

Greenwich Ltd., 728 F. Supp. 2d 372 (S.D.N.Y. 2010), and detailing the court's decision to "narrow"—but not dismiss—claims against a hedge fund, its custodian, auditor, and a calculator of the fund's net asset value while rejecting the notion that such negligence rose to securities fraud). *But see* Newman v. Family Mgmt. Corp., 748 F. Supp. 299, 302–03 (S.D.N.Y. 2010) (dismissing civil action by investors against a Madoff "feeder fund").

52. *See* Jeffrey Toobin, *Madoff's Curveball*, NEW YORKER, May 30, 2011, at 44 (detailing the Trustee's pursuit of Mets' Owner, Fred Wilpon, under the theory that he must have known about Madoff's fraud).

53. SEC Charges Two Longtime Madoff Employees with Fraud, SEC Litigation Release No. 21750, 99 SEC Docket 2925 (Nov. 18, 2010).

54. Malini Manickavasagam, *Grand Jury Indicts Longtime Madoff Execs; Two Allegedly Propped Up Elaborate Scheme*, 42 Sec. Reg. & L. Rep. (BNA) 2205 (Nov. 22, 2010) (describing cases against Annette Bongiorno and Joann Crupi).

55. *See, e.g.*, Liz Moyer, *How Regulators Missed Madoff*, FORBES (Jan. 27, 2009, 3:20 PM), http://www.forbes.com/2009/01/27/bernard-madoff-sec-business-wall-street_0127_regulators.html. Over a year later, the SEC's failures were still a hot topic for journalists. *See* Jenny Anderson & Zachary Kouwe, *The Enforcers*, N.Y. TIMES, Feb. 9, 2010, at B1; Michael Sherer, *The New Sheriffs of Wall Street*, TIME, May 24, 2010, at 22, 26 ("[I]n 2009, the [SEC] was on its heels, stung for missing Bernie Madoff's Ponzi scheme . . . ."). Also of interest to the press was the difficulty in figuring out how to compensate all of Madoff's victims. *See, e.g.*, Arthur J. Steinberg & John F. Isbell, *Resolution of Madoff Customer Claims: Still in Act One*, N.Y. L.J., Apr. 21, 2010, at 4.

56. A Form BD is the Uniform Application for Broker-Dealer Registration required for the SEC, self-regulatory agencies, and applicable jurisdictions. A copy of the form is available at http://www.sec.gov/about/forms/formbd.pdf (last visited Oct. 25, 2011).

in (or to be engaged in, if not yet active) by [the] applicant."[57] Yet, from 2006 through 2008, BLMIS only acknowledged two activities: "[b]roker or dealer making inter-dealer markets in corporate securities over-the-counter" and "[t]rading securities for own account."[58] Likewise, BLMIS did not identify "[i]nvestment advisory services" as a function of its business, although such option is (and was) listed in section 12 of the Form.[59]

In 2006, an SEC examination of BLMIS caused enough suspicions to prompt the instruction from the agency that the broker-dealer dually register as an investment advisor.[60] The subsequent Form ADV filed by BLMIS from January 2008 tautologically disclosed an affiliation between the broker-dealer and the investment advisor while understating the number of clients at twenty-three.[61] The arrest of Madoff and collapse of the Ponzi scheme precluded further BLMIS filings.

About two months after Madoff's arrest, it was announced that his investment business had not effected a single trade for over a dozen years.[62] The ensuing forensic studies conducted by the regulators detailed, in surreal fashion, a *non*-enterprise.[63] The flawed SEC examinations and lapses in regulatory judgment in ignoring tips and concluding examinations have been well-documented.[64] But perhaps the strongest indicia of the problems at Madoff's firm resulted from the actions that the regulator did take. For example, in the early 1990s, the SEC disciplined an entity that allegedly deposited the proceeds of thirty years of unregistered securities sales with (and received funds for introducing clients to) BLMIS.[65] For reasons not

57. *Id.*

58. *See* Bernard L. Madoff Inv. Sec. LLC, Uniform Application for Broker-Dealer Registration (Form BD) (Sept. 3, 2008); Bernard L. Madoff Inv. Sec. LLC, Uniform Application for Broker-Dealer Registration (Form BD) (Dec. 20, 2007); Bernard L. Madoff Inv. Sec. LLC, Uniform Application for Broker-Dealer Registration (Form BD) (Mar. 8, 2007); Bernard L. Madoff Inv. Sec. LLC, Uniform Application for Broker-Dealer Registration (Form BD) (Aug. 24, 2006).

59. *See* Bernard L. Madoff Inv. Sec. LLC, Uniform Application for Broker-Dealer Registration (Form BD) (Sept. 3, 2008).

60. *See* OIG REPORT, *supra* note 11, at 21–22.

61. *See* Complaint, *supra* note 9, at 4.

62. Martha Neil, *Madoff Made No Trades for Perhaps 13 Years, Trustee Says*, A.B.A. J. (Feb. 20, 2009, 2:42 PM), http://www.abajournal.com/news/article/madoff_made_no_trades_for_perhaps_13_years_trustee_says.

63. *See infra* note 73 and accompanying text.

64. *See supra* notes 10 and 11.

65. *See* SEC v. Avelino & Bienes, SEC Litigation Release No. 13443, 52 SEC Docket 2911 (Nov. 27, 1992) (describing the consent decree and leaving Madoff's firm unnamed). Neither BLMIS nor Bernard Madoff was disciplined by the SEC or other regulators for these events. *See also Preliminary Injunction and Other Equitable Relief Issued Against Avellino & Bienes, Frank Avellino and Michael Bienes*, SEC NEWS DIG., Nov. 30, 1992. *See also* OIG REPORT, *supra* note 11, at 26 ("The SEC suspected that Avellino & Bienes was operating a Ponzi scheme . . . . Yet,

articulated, the SEC did not believe that these defendants' fraud extended to Madoff's firm.[66]

Surprise over the fraud's length and simplicity later gave way to the roster (and ignorance) of victims. In general, well-heeled middlemen not only introduced investors to the scheme but, at times, allegedly worked to guard its creator. The owners of the New York Mets professional baseball team were said to have both restricted access to Madoff and provided year-end tax information to his advisory clients.[67] A related newspaper account told of "odd and puzzling terms that restricted direct contact with or questioning of Mr. Madoff" by introduced customers.[68] A book compilation detailed the exact nature of contacts (or lack thereof) between Madoff's victims and the enterprise.[69]

F. The Trustee

Furthering the bizarre battle between the government and Madoff are the unique means by which the scattered Madoff monies are being collected by a court-appointed receiver (i.e., the Trustee). In late April 2009, the Trustee demanded returns of such funds from over 200 investors and former employees;[70] this number (and the high profile of the customers) would later increase dramatically.[71] These actions ("clawback suits") centered on the efforts of the Trustee to recover not only the Madoff monies still capable of being located, but also allegedly transferred to counterparties serving

the OIG found that the SEC never considered the possibility that Madoff could have taken the money that was used to pay back Avelino & Bienes' customers from other clients as part of a larger Ponzi scheme.").

66. *See* OIG REPORT, *supra* note 11, at 6.

67. Serge F. Kovaleski, *Mets' Owners Guarded an Investment Pipeline*, N.Y. TIMES, Feb. 21, 2011, at A1 (detailing the efforts of one Mets Board member to manage or administer over 480 Madoff accounts for colleagues, friends, family members and related entities).

68. *Id.*

69. THE CLUB, *supra* note 32 (providing accounts from many different Madoff victims).

70. Therese Doherty et al., *Madoff Victims Face Litigation Landscape Filled with Uncertain or Unsatisfying Recoveries and, Worst of All, the Prospect of Losing More*, 2009 EMERGING ISSUES 3571, at *1, 2 (Apr. 30, 2009) (explaining, among other things, that direct investors with the Madoff broker-dealer would theoretically be covered by SIPC up to $500,000 in losses to securities and $100,000 in cash losses, while those investing "indirectly" through feeder funds "can hope only for a pro rata share of the $500,000 that will presumably be paid to each of the investing funds . . . ." (citing Sec. Investor Prot. Corp. v. Morgan, Kennedy & Co., 533 F.2d 1314 (2d Cir. 1976))).

71. *See* Anthony M. Destefano, *Madoff Victims' Deal Near*, NEWSDAY, July 12, 2011, at A36 (stating that 2,300 Investor claims had been approved by the Trustee).

(wittingly or unwittingly) as part of the Ponzi scheme.[72] In the bankruptcy court decision ("Bankruptcy Decision") determining the proper methodology for deciding both the eligibility and value of customer claims to SIPC, Judge Lifland provided a blunt synopsis of the Madoff scheme and the rationale for disregarding some Investor claims:

> Rather than engage in legitimate trading activity, Madoff used customer funds to support operations and fulfill other investors' requests for distribution of profits to perpetuate his Ponzi scheme. Thus, any payment of "profit" to a BLMIS customer came from another BLMIS customer's initial investment. Even if a BLMIS customer could afford the initial fake purchase of securities reported on his customer statement, without any additional customer deposits, any later "purchases" could be afforded only by virtue of recorded fictional profits. . . . [I]n Madoff's fictional world no trades were actually executed, customer funds were never exposed to the uncertainties of price fluctuation, and account statements bore no relation to the United States securities markets at any time.[73]

Throughout 2010, clawback suits were filed by the Trustee against a growingly impressive list of defendants.[74] Thus, the premises that trades had been fabricated and that some investors should have known better seemed to

72. *See* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 125–34 (Bankr. S.D.N.Y. 2010) (detailing the mechanics of Madoff's fraud and classifying the different victims).

73. *Id.* at 128.

74. *See, e.g.*, Anthony M. Destefano, *Trustee: Payback Time*, NEWSDAY, Oct. 23, 2010, at A10 (announcing the imminent Clawback Actions against "a lot of high rollers in the investment fraud"); Malini Manickavasagam, *Trustee Sues Former Milberg Partners for over $20 Million in Fictitious Profits*, 42 Sec. Reg. & L. Rep. (BNA) 2203 (Nov. 22, 2010) (describing the suit alleging that Melvyn Weiss and David Bershad—the two former partners of famed securities class action law firm Milberg Weiss—received more than $20 million in fictitious profits); Diana B. Henriques, *Madoff Trustee Sues JPMorgan for $6.4 Billion*, N.Y. TIMES DEALBOOK BLOG (Dec. 2, 2010, 8:12 PM), http://dealbook.nytimes.com/2010/12/02/madoff-trustee-sues-jpmorgan/?scp=1&sq=Madoff%20Trustee%20Sues%20JPMorgan%20for%20%246.4%20Billion&st=cse (quoting the Trustee as "contending that the bank bears some responsibility for the losses of victims because it continued to serve as Mr. Madoff's primary banker despite growing evidence that he was running an enormous fraud"). The claims against JP Morgan Chase Bank and related entities were later amended to seek $19 billion. *See* Anthony M. Destefano, *Madoff damages case now $19B*, NEWSDAY, June 25, 2011, at A14 [hereinafter Destefano, *Madoff Damages*]; *see also* Alison Leigh Cowan et al., *Trustee Faults Mets Owners Over Madoff Fraud*, N.Y. TIMES, Jan. 29, 2011, at A1 (targeting approximately 100 entities "owned or controlled in part" by the owners of the professional baseball team). *But see* Linda Sandler, *New York Mets Owners Again Seek To Have Madoff Trustee's Suit Thrown Out*, BLOOMBERG (July 8, 2011, 11:01 PM), http://www.bloomberg.com/news/2011-07-01/mets-owners-may-not-have-had-duty-to-probe-madoff-fraud-u-s-judge-says.html (noting that "judges have struggled with the duty of inquiry into fraud for more than half a century, and it may not have been the 'governing law' for the Mets owners").

have taken hold in the psyche of both the courts and the public. Not all parties, however, were appeased by the Trustee's aggressive recovery tactics; the Chair of the House Financial Services Capital Markets Subcommittee introduced legislation designed to "shield" certain Madoff clients from clawback suits.[75]

By the spring of 2011, the overall tally of convictions for the Madoff enterprise stood at three criminal pleas (including Madoff's accountant and "senior lieutenant") and five indictments;[76] the scheme itself enjoyed the reputation of "the biggest scandal in financial history,"[77] while its author evidenced an uncanny means of continuing to run afoul of the law.[78] In the most recent months, the SEC has continued—despite continuing surreal disclosures[79] and even Madoff lawsuits naming it as defendant[80]—to embrace the theory that Madoff operated a legitimate market making business for large Wall Street firms simultaneously with an illegal advisory business serving clients of every strata.[81] Despite all the embarrassing setbacks (or because of them), the besieged agency advertises on its web site the reforms occasioned by the Madoff experience.[82] Meanwhile, one consistency throughout the

75. *See Lawmaker Introduces Bill to Limit Madoff Trustee's Pursuit of Net Winners*, 43 Sec. Reg. & L. Rep. (BNA) 415, 415 (Feb. 28, 2011) (quoting Representative Scott Garrett as saying, "When investors see the Securities Investor Protection Corporation seal of approval, they should have the utmost confidence in the account statements they receive.").

76. *See* Henriques, *supra* note 3.

77. GASPARINO, *supra* note 2, at 495.

78. *See* Ellen Yan, *State Lists Biggest Tax Dodgers*, NEWSDAY, Mar. 12, 2011, at A26 (detailing Madoff's unpaid New York state tax bill of $1.6 million).

79. In late February 2011, it was disclosed that the SEC General Counsel was among those defendants sued by the Trustee as part of the Clawback Actions. *See* Peter Lattman, *Top S.E.C. Lawyer Sued by Madoff Trustee*, N.Y. TIMES DEALBOOK BLOG (Feb. 23, 2011, 12:58 PM), http://dealbook.nytimes.com/2011/02/23/top-s-e-c-lawyer-sued-by-madoff-trustee (describing the action by the Trustee to recoup $1.54 in alleged fictitious profits earned by the estate of the mother of the Commission's General Counsel); *see also* Yin Wilczek, *Key House Republicans Want Answers On SEC Counsel's Contacts With Madoff*, 43 Sec. Reg. & L. Rep. (BNA) 417, 417 (Feb. 28, 2011).

80. *See* Yin Wilczek, *SEC Hit With Class Action Alleging Gross Negligence in Oversight of Madoff*, 42 Sec. Reg. & L. Rep. (BNA) 2202, 2202–03 (Nov. 22, 2010) (describing the purported class action against the agency complaining of grossly negligent acts of the Commission in reviewing information concerning Madoff between 1992 and 2008); *see also Court Tosses Lawsuit Seeking to Hold Gov't Liable for Failing to Halt Madoff Fraud*, 43 Sec. Reg. & L. Rep. (BNA) 866, 866 (Apr. 25, 2011).

81. *See, e.g.*, *The Securities Exchange Commission Post-Madoff Reforms*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/secpostmadoffreforms.htm (last visited Oct. 25, 2011) (heralding the Commission's "Integrat[ion] of Broker-Dealer and Investment Adviser Examinations").

82. *See id.*

ordeal has been the banquet for prosecutors,[83] lawyers,[84] and trial and compliance experts[85] as the litigation landscape continued to grow as dense as any forest.[86]

Thus, the scorecard has become almost too full to follow. And it all started with the government embracing (and Madoff's acquiescence to) the notion that the con man had committed "securities fraud" as defined by securities regulators.[87]

II. RULE 10B-5: THE ELASTIC REMEDY

"Securities fraud" is a far-ranging offense tied to a defined list of required elements. At times, observance of these elements has prevented prosecution of blatantly pernicious behavior; at other times, "policy" has been cited as the rationale for sidestepping legal technicalities. Regardless, the offense is largely defined and always outlawed by SEC Rule 10b-5,[88] which reads in its entirety as follows:

83. *See, e.g.*, Mark Hamblett, *Interference With Counsel Claims in Madoff Probe Rejected*, N.Y. L.J., Apr. 7, 2011, at 1 (describing the court's upholding of prosecutors' seizure of "forfeitable assets" owned by three former BLMIS employees).

84. Aaron Smith, *Lawyers Make Millions off Madoff Mess*, CNNMONEY (Feb. 16, 2011, 11:38 AM), http://money.cnn.com/2011/02/16/news/companies/madoff_assets_lawyers_payments/index.htm (quoting Professor Ronald Colombo of Hofstra Law School as stating, "The only winners in the Madoff scandal are the lawyers . . . . But that's the nature of the beast," and noting that the Trustee's law firm had been paid over $128 million for its role in overseeing the SIPC liquidation).

85. *See* Clifford E. Kirsch, *The Madoff Scandal: Practical Compliance Considerations for Advisers*, COMPLINET (Jan. 15, 2009), http://www.complinet.com/global/news/news/article.html?ref=118208 (discussing steps legal experts should be taking to prepare for "an all-but-certain 'full court press' by the SEC"); *see also* AUDITOR LIABILITY IN THE CURRENT ENVIRONMENT: HOW TO PROTECT YOURSELF (PLI Corporate Law & Practice Course, Handbook Series No. B-1844, 2010) (discussing litigation and compliance issues that came to light in the wake of Madoff's Ponzi scheme).

86. *See, e.g.*, Daniel Scheeringa, *What Hath Madoff Wrought? Private Actions Under the Martin Act*, ILL. BUS. L.J. (Oct. 27, 2010, 9:00 PM), http://www.law.illinois.edu/bljournal/post/2010/10/27/What-hath-Madoff-Wrought-Private-actions-under-the-Martin-Act.aspx (describing the effect of *Anwar v. Fairfield Greenwich* upon sections 352 and 353 of New York's General Business Law which gives the New York Attorney General the right to take action against securities fraud).

87. *See, e.g.*, Alex Berenson & Diana B. Henriques, *Inquiry Finds No Signs Family Aided Madoff*, N.Y. TIMES, Dec. 16, 2008, at B1 (quoting the SIPC President as saying, "It is clear that the customers of the Madoff firm need the protections available under federal law.").

88. Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a) (2006), is virtually identical to Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010) (promulgated pursuant to section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006)). *See* LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES REGULATION 321 (7th ed. 2010) ("[W]hen the Commission drafted Rule 10b-5, it copied the numbered subdivisions of Section 17(a) almost

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[89]

Federal case law dating back decades both lists and attaches standards to the elements of a Rule 10b-5 claim. Regarding the first element, the accused must be proven to have acted with scienter, defined as a mental state evidencing an intent to deceive.[90] Second, the act, omission or statement in issue must be shown to have been material (i.e., significant enough to affect the related security).[91] Next, there must be proof of a deception upon a victim.[92] Additionally, in homage to the parting words of the storied prohibition, the "in connection with" requirement precludes attaching the moniker of "securities fraud" to outright theft of funds.[93] In cases brought by private plaintiffs, two additional requirements as to causation exist: 1) the defendant's acts must have caused the purchase or sale; and 2) that purchase or sale must have resulted in a loss.[94]

Where acts are targeted as "fraudulent acts," "schemes," or "practices" under sub-sections (a) or (c) of the Rule, the SEC must prove the full complement of these elements.[95] If the wrongful acts are described as "misstatements" under sub-section (b) of the Rule, the SEC must prove that "in connection with the purchase or sale of a security the defendant, acting with scienter, made a material misrepresentation (or a material omission if the

word for word."). Indeed, the two violations are routinely charged in tandem. *See, e.g.*, Jonathan G. Lebed, Exchange Act Release No. 33-7891, 73 SEC Docket 741, 742 (Sept. 18, 2000).

89. 17 C.F.R. § 240.10b-5 (2010).

90. Aaron v. SEC, 446 U.S. 680, 686, 695 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

91. TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438, 445–49 (1976).

92. United States v. O'Hagan, 521 U.S. 642, 651–53 (1997).

93. SEC v. Zandford, 553 U.S. 813, 825 n.4 (2002) ("If, for example, a broker embezzles cash from a client's account or takes advantage of the fiduciary relationship to induce his client into a fraudulent real estate transaction, then the fraud would not include the requisite connection to a purchase or sale of securities.").

94. Dura Pharm. Inc. v. Broudo, 544 U.S. 336, 341–42 (2005). *But see* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2183 (2011) (holding that plaintiffs need not prove loss causation to obtain class certification status).

95. *See Dura Pharm.*, 544 U.S. at 341–42.

defendant had a duty to speak)."[96] The "in connection with" requirement has, at times, resulted in the dismissal of SEC claims against unabashedly transgressing defendants.[97] Separately, where misstatements are alleged to have influenced or resulted in stock market trading, there is less debate over whether the statements were in connection with the activity.[98] Where a garden-variety theft of customer funds has occurred, Rule 10b-5, surprisingly, provides for counterintuitive results.

A. The "In Connection With" Conundrum

In perhaps the lead case specifically addressing the "in connection with" requirement, the Supreme Court construed the clause broadly so as to capture the fraud. The *Bankers Life* Court, in reversing dismissals by both the district and circuit courts in 1971, ruled tersely that "the fact that the transaction is not conducted through a securities exchange or an organized over-the-counter market is irrelevant to the coverage of section 10(b)."[99]

But a closer inspection of that seminal holding reveals a decision centered more on the nature of the defendant (a corporate officer) and direct injury to shareholders than on non-existent securities. To wit, Bankers Life had agreed to sell all of its Manhattan Casualty Company ("Manhattan") stock for $5 million to a defendant who had no cash; the defendant, in turn, schemed to use as payment a dually-pledged $5 million certificate of deposit financed by Manhattan's sale of treasury bonds.[100] In sum, the "proceeds due the seller" (i.e., Banker's Life) were misappropriated by a party intending to conclude a bond sale with another, with the elevated question being whether the detached bond sale rose to the level of a transaction "in connection with" the purchase of a security.[101]

Noting that Manhattan was "duped," the Court emphasized that the Securities Exchange Act "protects corporations as well as individuals" and that the act's commission by the defendant's officer was "irrelevant" to the

96. SEC v. Escala Grp., Inc., No. 09-Civ.-2646, 2009 WL 2365548, at *8 (S.D.N.Y. July 31, 2009) (citing SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1467 (2d Cir. 1996)).

97. *See, e.g.*, *supra* note 14 and accompanying text; *infra* note 231 and accompanying text.

98. *See, e.g.*, *In re* Carter-Wallace, Inc. Sec. Litig., 150 F.3d 153, 156 (2d Cir. 1998) ("We have broadly construed the phrase 'in connection with,' holding that Congress, in using the phrase 'intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and in connection therewith, so relying, cause them to purchase or sell a corporation's securities' (citing SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) (en banc)))." Likewise, cases involving stock touting over the Internet do not indulge much debate over the potential hurdle posed by the connection requirement. *See, e.g.*, SEC v. Park, 99 F. Supp. 2d 889, 900 (N.D. Ill. 2000).

99. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971).

100. *Id.* at 7–9.

101. *Id.* at 8–10.

requisite reasoning.[102] But, again, there had been a sale of bonds as part of a scheme to buy common stock, so the case actually stood more for connections between parties to actual transactions than to connections between stock and sellers of pure fancy.

Predictably, the issue of applicability of Rule 10b-5 to non-existent securities came back. In *Superintendent of Insurance v. Freedman* in 1977, an insurance company's sham securities transaction—while forming the basis for state law violations—was found not to constitute a basis for securities fraud as stated by Rule 10b-5.[103] In that case, a public company facing a loan default structured a phony transaction (in an actual company's stock) as a means of "funneling up" funds from its insurance company subsidiary.[104] However, although funds were transferred from the subsidiary to the parent, no actual stock was purchased.[105] Afterwards, the primary actor in the fraud was sued by the Superintendent of Insurance (who had been appointed by the court to take possession of the parent's finances).[106]

The district court dismissed the Rule 10b-5 claim, primarily relying on precedent cases speaking to the lack of deception attending cases involving corporate "purchasers or sellers."[107] The court also distinguished *Banker's Life* on the ground that, in the predecessor case "there was never any question that several securities transactions had occurred through which a fraud had been perpetrated."[108] Further, the *Freedman* court advised that "[t]he Rule [10b-5] should not be applied automatically to every allegedly fraudulent transaction arguably involving securities."[109]

B. The Zandford *Dicta*

The debate over the ideal flexibility of the language was no doubt in mind when the Supreme Court took up the debate anew in 2002 in *SEC v. Zandford*.[110] While the SEC ultimately won the case (because the defendant did cause the liquidation of some of his clients' holdings before engaging in outright theft), the Court clarified that the "in connection with" analysis remained a challenging scrutiny. In doing so, the *Zandford* Court also reiterated that the broad notion of any "fraudulent conversion" in a brokerage

102. *Id.* at 9–10.
103. Superintendent of Ins. v. Freedman, 443 F. Supp. 628, 636 (S.D.N.Y. 1977).
104. *Id.* at 631–33.
105. *Id.* at 632–33.
106. *Id.*
107. *Id.* at 635 (citing Goldberg v. Meridor, 567 F.2d 209, 215 (2d Cir. 1977).
108. *Freedman*, 443 F. Supp. at 634.
109. *Id.* at 636.
110. SEC v. Zandford, 535 U.S. 813 (2002).

account constituting a Rule 10b-5 violation was "quite a leap" from precedent.[111]

In *Zandford*, a Maryland stockbroker was granted discretionary authority and power of attorney over an account owned by two customers, one of whom was mentally challenged.[112] The stockbroker, through over twenty-five withdrawals, transferred the customers' monies to accounts he controlled.[113] Over a four-year period, all of the $419,255 deposited by the customers vanished.[114] The stockbroker was convicted of wire fraud based upon the withdrawals, some of which were enabled by the unauthorized liquidation of mutual fund sales.[115] The SEC subsequently brought suit for violations of Rule 10b-5.[116]

The Maryland District Court granted the SEC summary judgment, but the Court of Appeals for the Fourth Circuit reversed, finding that the SEC's civil complaint had failed to allege a necessary connection between the sale of securities and a fraud that "lay in absconding with the proceeds."[117] The circuit court elaborated that Zandford's "scheme was simply to steal [customers'] assets," and that the occasionally enabling sales of mutual fund shares triggered by the defendant's check requests were transactions conducted in "a routine and customary fashion."[118]

In attempting to chart the reaches of Rule 10b-5, the *Zandford* Court actually weighed two scenarios traditionally advanced by the Commission: 1) where a broker "accepts payment for securities that he never intends to

111. The entire exchange between SEC counsel and the Court during oral argument reads as follows:

> [COURT]: Well, do you say then that any fraud by a broker in connection with a customer is actionable by the SEC[?]
>
> [SEC Counsel]: That goes back to the question that Justice Scalia asked me, Your Honor. And under the theory that we are advocating here, and for the Court to rule for us here, you don't need to conclude that. The SEC does take that position.
>
> [COURT]: Does take what position?
>
> [SEC Counsel]: That any fraudulent conversion by a broker from a brokerage account is a violation of 10(b) because it's fraud and it's in connection with the purchase or sale of securities; because the very purpose of the brokerage account is to buy and sell securities. And the broker has access to the customer's assets—
>
> [COURT]: That's quite a leap—
>
> [SEC Counsel]: —for the purpose of—
>
> [COURT]: That's a leap from any case we've ever decided.

Transcript of Oral Argument at 5–6, SEC v. Zandford, 535 U.S. 813 (2002) (No. 01-147).

112. *Zandford*, 535 U.S. at 815.

113. *Id.*

114. *Id.*

115. *Id.* at 815–16.

116. *Id.* at 816.

117. *Zandford*, 535 U.S. at 816–17.

118. *Id.* at 817–18.

deliver," and 2) where a broker "sells . . . securities with intent to misappropriate the proceeds."[119] (The two theories traditionally advanced by the SEC shall be hereinafter referred to as the "Dual Notions.") The Court ultimately declared its deference to the construct of both of these dual notions "if it is reasonable."[120] But in rejecting the defendant's arguments, the *Zandford* Court clarified that it was primarily focused on belying the assertion that lawful mutual fund sales provided a disconnect to unlawful "misappropriation of the proceeds."[121] Manifestly, the Court, by emphasizing the timing of the fraud, held true to varied 10b-5 and fraud related precedent[122] by finding that Zandford's fraud "coincided with the sales themselves."[123]

The more applicable guidance regarding nonexistent securities thus comes from oral argument, where the SEC tailored its approach to the facts in issue while—in eerily predictive fashion—confessing 10b-5's limits:

> [SEC Counsel]: For instance a broker could defraud customers by convincing them to pursue an investment advisory relationship. And that would not be - - that would not necessarily be covered [by Rule 10b-5].
>
> In addition, the broker might defraud the customers of assets that are outside of the brokerage account and that aren't securities because the broker has developed a relationship of trust with the customer. That wouldn't be covered under [the SEC's Dual Notions].[124]

The Court thus observed the misappropriation exception without ever considering the scenario of securities fraud in the absence of purchase or sales. Significantly, the *Zandford* Court noted that the *Bankers Life* Court "did not ask whether 'the fraud involved manipulation of a particular security,'"[125] emphasizing, instead, that the Securities Exchange Act "must be read flexibly, not technically and restrictively."[126]

Subsequent to *Zandford*, the Eleventh Circuit took the spirit of flexibility further in *Grippo v. Perazzo*, accepting both of the Dual Notions in holding that a 10b-5 plaintiff "does not need to identify a specific security, or

119. *Id.* at 819.

120. *Id.* at 819–20.

121. *Id.* at 820.

122. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 652 (1997) (holding that, for purposes of finding an insider trading conviction, "a person commits fraud 'in connection with' a securities transaction . . . when he misappropriates confidential information for securities trading purposes"); United States v. Dunn, 268 U.S. 121, 131 (1925) (finding that exercising the defendant's "power of disposition for his own benefit" constitutes a fraud).

123. *Zandford*, 535 U.S. at 820–21 (citation omitted).

124. Transcript of Oral Argument, *supra* note 111, at 15–16.

125. *Zandford*, 535 U.S. at 821.

126. *Id.* (citing Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971)).

demonstrate that his money was actually invested in securities."[127] Such application by the *Grippo* court, however, relied on the finding of a presence of an investment contract, normally subject to the famed test announced six decades ago by the Court in the *W.J. Howey* case.[128] Further, other circuits found *Zandford*'s flexible language as spawning a "special rule" based on the decision's dicta.[129] This special rule exception thus allows broad application of 10b-5 despite the "in connection with" requirement in instances in which securities were purchased "that the broker never intended to deliver,"[130] curiously at odds with *Zandford*'s primary emphasis upon coincidental misconduct and sales, and actually only adhering to the non-controversial half of the Dual Notions.

C. The SLUSA Twist

Finally, in the context of removal of class actions under the Securities Litigation Uniform Standards Act ("SLUSA"),[131] courts have fluctuated on the issue of whether purchases of securities need to be shown.[132] The factors weighed by the courts in such cases range from coincidental conduct to

127. Grippo v. Perazzo, 357 F.3d 1218, 1223 (11th Cir. 2004) (reversing a district court's dismissal of the complaint for failure to plead securities purchases where "no proof exists that a security was actually bought or sold").

128. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

129. *See* Ormond v. Anthem, Inc., No. 1:05-cv-1908-DFH-TAB, 2008 WL 906157, at *13–14 (S.D. Ind. Mar. 31, 2008) (finding the "in connection with" language not satisfied where the plaintiff failed to plead either that he purchased a security or "thought that he had purchased or sold a security"); Schnorr v. Schubert, No. CIV-05-303-M, 2005 WL 2019878, at *5 (W.D. Okla. Aug. 18, 2005) (equating "unfulfilled promises to purchase securities" with "actual purchases"). For purposes of this Article, the Supreme Court language inspiring these holdings will be referred to as the "*Zandford* Dicta."

130. *Ormond*, 2008 WL 906157, at *13 (citing *Grippo*, 357 F.3d at 1223; *Zanford*, 535 U.S. at 819–20).

131. 15 U.S.C. § 78bb(f)(1)–(3) (2006).

132. *Compare* Rowinski v. Salomon Smith Barney Inc., 398 F.3d 294, 304–05 (3d Cir. 2005) ("Although plaintiff scrupulously avoids pleading the words 'purchase' or 'sale' of securities, a reasonable reading of the complaint, informed by existing 'in connection' doctrine, establishes that the elements of SLUSA preemption are satisfied."), *with* Abada v. Charles Schwab & Co., 127 F. Supp. 2d 1101, 1103 (S.D. Cal. 2000) ("Even reading the 'in connection with . . .' language broadly . . . [the plaintiff's loss] was not the result of market manipulation or misrepresentations concerning the risk of a particular investment or investment system."). Fictitious investments are more readily reached by SLUSA, as the statute expressly defines "covered security" to include open and closed-end funds. *See Court Says Claims by Foreign Investors In Madoff Feeder Funds Barred by SLUSA*, 43 Sec. Reg. & L. Rep. (BNA) 2414 (Dec. 5, 2011).

Zandford's failure to deliver exception, to definitions found within the securities laws themselves.[133]

Thus, the "in connection with" case law from the past forty years most readily evidences a desire to punish acts and omissions of immediate consequence; this policy is premised first upon fraud coincident with a transaction, and second upon factors ranging from the concrete (e.g., reimbursement of stolen funds) to the idyllic (e.g., necessity to effectuate the securities laws). More specifically, the case law reveals a disjunctive test at times favoring the presence of a tangentially related purchase or sale,[134] a misrepresentation by the defendant,[135] misconduct coinciding temporally with securities transactions,[136] a failure to deliver on a promise,[137] and/or the broad, remedial purpose of the securities laws.[138]

Overall, as textbook authors have explained:

> In other words, there are numerous possible ways of establishing "in connection with." You will see in the insider trading and broker-dealer areas, for example, that secret breaches of fiduciary duty are actionable so long as the fiduciary was trading in securities as an integral part of the scheme . . . . But one organizing principle seems to be that the fraud must relate to investment activity of the sort Congress was seeking to protect via the securities laws. In other words, the investment aspect must be "essential" to the wrongful scheme, rather than an incidental element.[139]

Simply stated, the most consistent reading of Rule 10b-5—which itself was adopted to counter a specific series of fraudulent stock transactions[140]—

133. *See Rowinski*, 398 F.3d at 302 (utilizing a four-part test implicating *Zandford*, the breadth of any misrepresentations by the defendant, the nature of the parties' relationship, and whether state law claims are connected to a purchase or sale of securities); *Ormond*, 2008 WL 906157, at *12–13 (weighing both "coincident" behavior and the investor's belief that a security was to be purchased); *Schnorr*, 2005 WL 2019878, at *6 (highlighting the failure to deliver exception, the coincidental conduct, and the definition of "purchase" within the Securities Exchange Act); *Abada*, 127 F. Supp. 2d at 1103 (relying primarily on the overall purposes of the Securities Act and the Securities Exchange Act).

134. *See, e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

135. *See, e.g.*, Grippo v. Perazzo, 357 F.3d 1218, 1222 (11th Cir. 2004).

136. *See, e.g.*, SEC v. Zandford, 535 U.S. 813, 820 (2002).

137. *See, e.g.*, *Grippo*, 357 F.3d at 1223–24.

138. *See, e.g.*, *Zandford*, 535 U.S. at 819; *Abada*, 127 F. Supp. 2d at 1103.

139. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 662 (6th ed. 2009).

140. *See* Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967) (explaining the unremarkable Commission decision around 1943 to adopt Rule 10b-5—and thus extend Securities Act § 17(a)—in response to a Boston fraud).

requires some related purchases of securities.[141] And where no such purchases can be found, the SEC and private plaintiffs alike run the risk of claims failing; indeed, federal courts since 2008 have on occasion dismissed SEC actions when no "security" could be located.[142] And the *Zandford* Dicta (i.e., that *any* fraud tangentially connected to a securities account equates with "securities fraud") remains a questionable premise with which to charge fraudsters.[143]

III. RULE 10B-5 AND PONZI SCHEMES

Ironically, decades of expansive case law nonetheless poses a problem in stretching Rule 10b-5 to reach all Ponzi schemes, some of which start with modest (or even benevolent) intentions, most of which emphasize returns while discounting specific investments, and all of which (by definition) meet at least some investors' expectations. Accordingly, to effectuate and perpetuate its role as army of first resort in anything colored as "securities fraud," the SEC has had to employ a variety of statutory approaches to reach scam artists.

The SEC has consistently evidenced a healthy intolerance of Ponzi schemes,[144] litigating against their promoters on an array of theories under

141. *See supra* notes 98 and 101 and accompanying text. *But see* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 84–86 (2006) (finding that actual purchases are not necessary to remove state court class actions to federal court pursuant to SLUSA).

142. *See, e.g.*, Malini Manickavasagam, *Claims Against Madoff Feeder Funds, Gatekeepers May Proceed*, 42 Sec. Reg. & L. Rep. (BNA) 1587, 1587 (Aug. 23, 2010) (relating the refusal of the U.S. District Court for the Southern District of New York, hearing *Anwar v. Fairfield Greenwich Ltd.*, to dismiss the complaint on grounds of preemption by the Securities Litigation Uniform Standards Act ("SLUSA")). One district court noted that "stretching SLUSA to cover this chain of investment—from Plaintiff's initial investment in the Funds, the Funds' reinvestment with Madoff, Madoff's supposed purchases of covered securities, to Madoff's sale of those securities and purchases of Treasury bills—snaps even the most flexible rubber band." *Id.* The court thus allowed the case to proceed under a theory of negligence, as opposed to a theory of securities fraud. *Id.*

143. *See, e.g.*, *Online Broker That Did Not Sell or Buy Securities Lacks Fraud Standing, Court Holds*, 43 Sec. Reg. & L. Rep. (BNA) 786 (Apr. 11, 2011) (discussing *Scottrade v. BroCo Investments Inc.*, in which the U.S. District Court for the Southern District of New York dismissed for lack of a connected purchase a Rule 10b-5 claim against hackers who had misappropriated from the brokerage's customer accounts).

144. *See Colorado Note Marketer Consents To Antifraud Charges for his Role in $314 Millon Ponzi Scheme, Accepts Bar from Association with any Broker or Dealer*, SEC NEWS DIG., June 26, 2002, at 1–2, *available at* http://www.sec.gov/news/digest/06-26.txt (detailing a Colorado marketer's consent to an antifraud order); *SEC Charges Tamarack Funding Corp. and Garry Isaacs with Securities Fraud*, SEC NEWS DIG., June 1, 2000, at 9–10, *available at* http://www.sec.gov/news/digest/2000/dig060100.pdf (detailing the enforcement action against Tamarack Funding Corporation based in part upon use of new investor funds to repay existing investors, with the defendants thus engaging "in a Ponzi scheme"). Undoubtedly, the SEC's targeting of Ponzi schemes intensified after December 2008. *See* Elisse B. Walter, Commissioner, SEC, Custody of Funds or Securities of Clients by Investment Advisers (Final

varied statutory sections, even in the presence of state laws directly on point.[145] Indeed, section 5 of the Securities Act of 1933,[146] the means by which the agency compels securities registration, has been applied to Ponzi schemes for decades.[147] In the main, the SEC has (successfully) added itself to the list of parties of interest attending headline frauds through actions attacking notorious financial scams directly[148] and indirectly.[149] But while "Ponzi scheme" may have occasionally proven to be a shibboleth, the mere utterance of which triggers SEC action, a closer analysis of the actions brought by the Commission reveals a distinct, discernible categorization. To wit, cases (which are routinely brought in addition to parallel criminal cases, and are almost always settled) tend to fall into three types.

A. Limited Partnership/Note Cases

Where frauds are perpetrated through the sale of limited partnership units or notes, the Ponzi scheme readily fits under the statutory definition of a "security." Thus, in the first five months after the Madoff revelations, the Commission blanketed the press with news of numerous Ponzi frauds punishable under Rule 10b-5 linked to securities covered by the broad, user-friendly terms within the securities laws.[150]

Rule) (Dec. 16, 2009), *available at* http://www.sec.gov/news/speech/2009/spch121609ebw-custody.htm (discussing a new SEC rule designed to protect against misuse of investor assets); Mary L. Schapiro, Chairman, SEC, Statement on the Release of the Executive Summary of the Inspector General's Report Regarding the Bernard Madoff Fraud (Sept. 2, 2009), *available at* http://www.sec.gov/news/speech/2009/spch090209mls-2.htm ("Although numbers cannot tell the entire story, already we have filed more than twice as many emergency temporary restraining orders this year related to Ponzi schemes and other frauds, as compared to the same period last year."); *Ponzi Schemes—Frequently Asked Questions*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/answers/ponzi.htm (last visited Nov. 15, 2011).

145. *See, e.g.*, SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 n.8 (9th Cir. 1973) (noting that "the laws of three states" had previously found the defendant's scheme to involve the fraudulent sale of securities).

146. 15 U.S.C. § 77e (2006).

147. *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 484–85 (5th Cir. 1974) (finding a security for purposes of section 5 of the Securities Act in a recruitment plan); *Glenn W. Turner Enters.*, 474 F.2d at 482 (finding an investment "scheme" likely to result in market saturation to be a "security" for purposes of section 5 of the Securities Act).

148. *See, e.g.*, SEC v. SG Ltd., 265 F.3d 42, 55 (1st Cir. 2001) (finding SEC Complaint to sufficiently allege facts that, if proven, would show virtual stocks to be a "security" for purposes of the securities laws).

149. *See supra* note 146.

150. *See, e.g.*, Press Release, SEC, SEC Charges California Promoter for Operating Ponzi Scheme Targeting Hispanic-American Community (Apr. 13, 2009), *available at* http://www.sec.gov/news/press/2009/2009-79.htm (promissory notes); Press Release, SEC, SEC Charges Georgia Attorney for Conducting Multi-Million Dollar Ponzi Scheme (Apr. 9, 2009), *available at* http://www.sec.gov/news/press/2009/2009-77.htm (promissory notes); Press Release,

This acceptable product nexus was at the core of the SEC's prompt action against Robert Allen Stanford,[151] the fraudster popularized in conjunction with Madoff as poster boys for Ponzi artists from 2008. In that case, the accused fraudster's use of certificates of deposits ("CDs") readily brought the activity within the language of Rule 10b-5.[152]

B. The "Misstatement" Cases

Likewise, where the defendant has simply lied to investors about the purchase of securities and absconded with the proceeds, the case law has fairly consistently treated the lie as triggering sub-section (b) of Rule 10b-5 (i.e., an "untrue statement of a material fact").[153] Thus, cases involving purely fictitious securities trading can surmount the obstacle posed by the "in connection with" language's requirement that actual securities be purchased or sold where the falsehood can contemporaneously be traced to the defendant's lips.[154]

SEC, SEC Charges Colorado Advisor for Conducting Multi-Million Dollar Ponzi Scheme (Apr. 8, 2009), *available at* http://www.sec.gov/news/press/2009/2009-75.htm (limited liability company units); Press Release, SEC, SEC Obtains Asset Freeze In Ponzi Scheme Targeting Chinese-American Community in Dallas Area (Apr. 6, 2009), *available* at http://www.sec.gov/news/press/2009/2009-74.htm (limited partnership units); Press Release, SEC, SEC Charges Joseph S. Forte for Conducting Multi-Million Dollar Ponzi Scheme (Jan. 8, 2009), *available at* http://www.sec.gov/news/press/2009/2009-5.htm (limited partnership units).

151. SEC Obtains Temporary Restraining Order, Asset Freeze, and Other Relief Against Defendants, SEC Litigation Release No. 20901, 95 SEC Docket 658 (Feb. 17, 2009).

152. *See* Jason Ryan & Maddy Sauer, *Billionaire Allen Stanford Indicted, Charged with Fraud, Obstruction*, ABC NEWS ONLINE (June 19, 2009), http://abcnews.go.com/Blotter/WallStreet/story?id=7881721&page=1 (describing the Department of Justice twenty-one-count indictment of Stanford for his alleged fraud, conspiracy, and obstruction of justice stemming from his sale of $7 billion of CDs from the Stanford International Bank). Regrettably, contrary to the instructions of the SEC, SIPC did not conclude that investors with Stanford (who also ran a registered broker-dealer) should be reimbursed for their losses. *See* Robert Schmidt and Joshua Gallu, *SEC's Stanford Ponzi Ruling Provokes Clash With Investor Fund*, BLOOMBERG (July 21, 2011, 5:00 AM), http://www.bloomberg.com/news/2011-07-21/sec-s-stanford-ponzi-ruling-provokes-clash-with-investor-fund.html; *see also infra* notes 205–216.

153. *See supra* notes 88–89 and accompanying text.

154. *See, e.g.*, Complaint at 2, SEC v. Nadel, No. 11 Civ. 0215 (E.D.N.Y Jan. 13, 2011), *available at* http://www.sec.gov/litigation/complaints/2011/comp21812.pdf ("Defendants' conduct was fraudulent. In numerous communications with clients and prospective clients, Defendants deliberately overstated the value and liquidity of client holdings in the Strategy."); Press Release, SEC, SEC Charges Massachusetts-Based Forex Traders and Their Firm With Fraud (Oct. 28, 2010), *available at* http://www.sec.gov/news/press/2010/2010-205.htm (quoting the Director of the SEC Division's Enforcement: "The bait was the promise by [the two defendants] to limit investor risk, and the switch was the theft and unauthorized trading that cost investors 90 percent of the invested funds . . . .").

C. Investment Advisers Act Cases

But the type of fraud that poses the biggest obstacle to application of Rule 10b-5 is the one centering purely on an investment in a generalized fund. In such scenario, no securities are immediately or imminently purchased or sold, and the lie appears delegated, or at least temporally removed from the theft. Thus, another means of statutory attack by the Commission must be found.

For example, in the spring of 2011, the SEC brought suit against an unregistered investment adviser in Connecticut.[155] The Commission alleged "Ponzi activity" among a holding company and several hedge funds.[156] The claims were fashioned as violations of the anti-fraud provision of the Investment Advisers Act of 1940.[157] In that case, the "management fees" taken as compensation from the funds by the principal and others were said to be tantamount to misappropriation because the defendants had "manufactured both the assets under management and the performance figures for the funds."[158] Of particular note are the allegations that assets did not exist[159] and that investment monies were diverted "into bank accounts that [the defendant] personally controlled"[160]—in short, the Commission charged an Investment Advisers Act violation for activity strikingly similar to the Madoff modus operandi.

In sum, Ponzi schemes are most readily reached by Rule 10b-5 when utilizing an investment vehicle that by name connotes the protection of the securities laws. As is evident, a plethora of SEC cases target the delusional yet concrete sales of promissory notes, a vehicle expressly delineated in the definitional section of both the Securities Act of 1933 and the Securities Exchange Act of 1934.[161] These cases, while ultimately tied to non-performance, nonetheless identify a tangible document or arrangement fitting within the expressed statutory scope of the securities laws.[162] Failing such a

155. First Amended Complaint at 1–2, SEC v. Illarramendi, No. 3:11 Civ. 00078 (D. Conn. Mar. 7, 2011).

156. *Id.*

157. 15 U.S.C. § 80b-6(4) (2006). Companion Rule 206(4)-8, 17 C.F.R. § 275.206(4)-8 (2010), was contemporaneously charged. First Amended Complaint, *supra* note 155, at 13.

158. First Amended Complaint, *supra* note 155, at 3.

159. *Id.* at 2.

160. *Id.*

161. 15 U.S.C. § 77b(a)(1) (2006) and 15 U.S.C. § 78c(a)(10) (2006), respectively.

162. *See, e.g.*, Complaint at 2, 22, SEC v. Zufelt, No. 2:10 Civ. 00574 (D. Utah June 23, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp21570.pdf (charging Rule 10b-5 violations for, in part, sales of promissory notes); Press Release, DOJ, Gainesville, Florida Man Arrested for His Role in a $30 Million Ponzi Scheme, (Nov. 4, 2010), *available at* http://www.justice.gov/opa/pr/2010/November/10-crm-1253.html (stating criminal charges tied to purchase/sales of foreign currency where "only a small portion of these investor funds in trading activities" that "generated little if any profits").

textual lynchpin, the case law rushes to apply the misstatements subdivision of the famed Rule to cover the pernicious activity. But where the scam artist has simply segregated funds for possible looting at a point to be determined later, the SEC apparently has the difficult choice to charge the activity under Rule 10b-5 (promulgated pursuant to the Securities Exchange Act) or section 206 of the Investment Advisers Act;[163] for purposes of either freezing assets or reimbursing "broker-dealer" customers under the Securities Investor Protection Act,[164] that choice can be vital.

IV. SIPC: MISSION AND DESIGN

SIPA expressly amends the Securities Exchange Act of 1934 (which addresses stock exchanges, broker dealers, and clearing agencies) but is not tied to the Investment Advisers Act, the eponymous regulation for investment advisers. SIPC, the resulting insurance fund for failed broker-dealers, although often compared to the Federal Deposit Insurance Corporation, holds assets dwarfed by comparison; until 2010, it charged member broker-dealers a flat annual fee of $150 and relied on a $1 billion line of credit with the federal government in times of crisis.[165]

A. Background

SIPA was adopted after a period in which numerous brokerages had failed.[166] The law was designed to both restore investor confidence in the market and prevent a feared "domino effect" among firms.[167] In recent decades, decreased public confidence caused by industry "complacency" has emerged as the primary concern during SIPA liquidations.[168] At times, SIPA liquidation proceedings provide a more expedient distribution of customer property than might be available in a bankruptcy proceeding.[169]

163. 15 U.S.C. § 80b-6 (2006).

164. *See* Complaint, *supra* note 9, at 1 (charging, for purposes of halting "ongoing fraudulent offerings of securities and investment advisory fraud" by Madoff and his firm, violations of both the Investment Advisers Act and Rule 10b-5).

165. U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-92-109, SECURITIES INVESTOR PROTECTION; THE REGULATORY FRAMEWORK HAS MINIMIZED SIPC'S LOSSES 2 (1992).

166. HAZEN & RATNER, *supra* note 16, at 204.

167. *See id.*

168. *See* U.S. GEN. ACCOUNTING OFFICE, *supra* note 165, at 35; *see also* Picard v. Katz, No. 11 Civ. 3605(JSR), 2011 WL 4448638, at *6 (S.D.N.Y. Sep. 27, 2011) ("The point [of SIPA], once again, is to provide stability in the securities markets by imparting a greater degree of certainty to securities transactions than to other kinds of transactions.").

169. Stephen P. Harbeck, *Stockbroker Bankruptcy: The Role of the District Court and the Bankruptcy Court Under the Securities Investor Protection Act*, 56 AM. BANKR. L.J. 277, 284–85 (1982).

As the courts clarified long ago, SIPA's sole enforcer is the SEC, as opposed to the Investment Advisors Act, which contemplates private enforcement.[170] After a broker-dealer's insolvency, SIPA provides for customer reimbursements (alternatively termed "advances" or "claims") pursuant to several sections of the Act.[171] Notably, the definition of "customer" appearing at § 78fff-2(e)(4) of the SIPA specifically exempts claims for cash contributed to the capital of the enterprise. The full definition reads as follows:

> For purposes of this subsection, the term "customer" does not include any person who –
>
> (A) is a broker or dealer;
>
> (B) had a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, was part of the capital of the claiming broker or dealer or was subordinated to the claims of any or all creditors of such broker or dealer; or
>
> (C) had a relationship of the kind specified in section 78fff-3(a)(5) of this title with the debtor.
>
> A claiming broker or dealer shall be deemed to have been acting on behalf of its customers if it acted as agent for such customer or if it held such customer's orders which was to be executed as a part of its contract with the debtor.[172]

With broker-dealers being specifically excluded from the class of creditors able to file claims against the bankrupt broker-dealer, SIPA clarifies that broker-dealers can only file where such claims "arose out of transactions for customers . . . in which event each such customer . . . shall be deemed a separate customer of the debtor."[173] Thus, a broker-dealer customer cannot recover monies in a SIPA liquidation unless able to prove that its account was maintained at the debtor broker-dealer for the purpose of effecting transactions for non-broker-dealer customers.

As has been consistently commented upon by the experts, the practical utility of SIPA has been to insure brokerage custodians against insolvency.[174] Accordingly, any analysis of a SIPA claim must be weighed 1) in terms of the

170. *See* Abrahamson v. Fleschner, 568 F.2d 862, 874 n.19 (2d Cir. 1977) ("Unlike the Securities Investor Protection Act . . . the [Investment] Advisers Act in general, and the antifraud provisions in particular, do not manifest a specific legislative intent to restrict enforcement to the Commission.").

171. *See* 15 U.S.C. §§ 78fff-2(b), 78fff-3(a) (2006).

172. *Id.* § 78fff-2(e)(4).

173. *Id.* § 78fff-3(a)(5).

174. *See, e.g.*, JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 57 (11th ed. 2009) ("[T]he Securities Investor Protection Corporation . . . was created by virtue of a 1970 amendment in order to establish an analogue to the Federal Deposit Insurance Corporation and thereby protect investors from the risk that their brokerage firms would become insolvent . . . .").

definition of "customer," 2) in terms of exceptions to the definition (e.g., broker-dealers), and 3) in terms of the general purpose of the Act. SIPC disbursements are determined by the statutory trustee; the SEC serves only as a potential party in interest in related litigation.[175] And SIPC trustees have not been shy about excluding from coverage those victimized by a broker-dealer's extraneous activities.[176]

B. *The Location of the Assets*

To understand how the SIPA liquidation is working in the Madoff case, first it must be determined where the assets were when insolvency struck (i.e., when attempted Investor redemptions outpaced assets). If any questions persisted about the stock activity—or lack thereof—in the Madoff scheme, the notion was resolutely laid to rest in one of the highest profile clawback suits filed to date. Specifically, in his filing seeking $300 million from the principals of a private company that owns the New York Mets professional baseball team, the Trustee asserted the following:

> 31. [Bernard L. Madoff Securities'] I[nvestment] A[dvisor] Business customers received fabricated monthly or quarterly statements showing that securities were held in, or had been traded through, their accounts. The securities purchases and sales shown in such account statements never occurred and the profits reported were entirely fictitious. At the Plea Hearing, Madoff admitted that he never purchased any of the securities he claimed to have purchased for the IA Business' customer accounts. In fact, there is no record of BLMIS having cleared a single purchase or sale of securities in connection with the [options trading] Strategy. Madoff's [options trading] Strategy was entirely fictitious.
>
> 32. At times prior to his arrest, Madoff generally assured customers and regulators that he purchased and sold the put and call options over-the-counter ("OTC") rather than through an exchange. Yet, like the underlying securities, the Trustee has yet to uncover any evidence that Madoff ever purchased or sold any of the options described in customer statements. The Options Clearing Corporation, which clears all option contracts based upon the stocks of S&P 100 companies, has no record of the IA Business having bought or sold any exchange-listed options on behalf of any of IA Business customers.[177]

175. 15 U.S.C. §§ 78fff-1(b), 78eee(c); *see also* § 78lll(1) (defining "Commission" as the SEC).

176. *See* Foster v. Nat'l Union Fire Ins. Co., 902 F.2d 1316, 1317, 1320 (8th Cir. 1990) (noting SIPC's denial of coverage to broker-dealer customers—who sought to recover $700,000 in securities "lost due to fraudulent and dishonest acts" by the firm's president—in upholding the contractual liability of a fidelity bond insurer for the same).

177. Complaint at 12, Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 454 B.R. 285 (S.D.N.Y. 2011) (Adversary No. 08–01789).

There being no securities trades on behalf of customers (whether they be "Madoff customers" or "BLMIS customers"), the overarching question for purposes of SIPC coverage becomes whether BLMIS was truly "custodial."[178] The most reliable evidence of the specifics of Madoff investor trades may come from the charges brought against Madoff's accomplices, cases brought long after his terse allocution in March 2009.[179] It is worth repeating that Madoff executed no securities trades for his investment advisory clients;[180] further, the "legitimate" market-making and proprietary trading activities of BLMIS have not been alleged by the government to have utilized Investor accounts.[181] The BLMIS statements themselves were said to have ranged from showing cash only at the end of the month[182] (while referencing trades of incalculable numbers of securities[183]) to positions wholly unrelated to the investment advisory "victims."[184] In short, vast amounts of Investor monies were kept outside of the broker-dealer for future looting while Investors

Two items here are noteworthy: First, the Trustee's actions are captioned against the Broker-Dealer—indeed, jurisdiction is severely limited over the approximately 10,000 investment advisors in the United States. *See* FINRA REPORT, *supra* note 10, at 65 ("FINRA lacks the authority to inspect for or enforce compliance with the Investment Advisers Act.").

Second, while the Trustee's complaint communicates that the Options Clearing Corporation has no records of option trades "on behalf of any of IA Business customers," Madoff's broker-dealer (which engaged in market-making activities and proprietary trading) did own option positions. *See* OIG REPORT, *supra* note 11, at 39–40 (detailing the numbers of $18–$26 million worth of S&P 100 equity options in the broker-dealer account in 2005 and 2006 according to Depository Trust Corporation records). The Trustee's carefully worded pleading against Sterling thus underscores the potentially fatal consequence of Madoff's empire being described as homogenous. *See also infra* notes 180–81. In September 2011, upon certification of certain issues raised in the SIPC lawsuit, Judge Jed S. Rakoff of the Southern District of New York reduced both the legal claims against, and the monies sought, from the Sterling defendants. *See* Picard v. Katz, No. 11 Civ. 3605(JSR), 2011 WL 4448638, at *1 (S.D.N.Y. Sep. 27, 2011).

178. *See supra* note 174 and accompanying text.

179. *See supra* note 12 and accompanying text.

180. *See* FINRA REPORT, *supra* note 10, at 47 ("According to the SEC, the Madoff firm never executed a single securities trade in the course of the investment advisory business, nor did it engage other brokers to execute such trades. The client account statements, order tickets, trade confirmations, and other documentation relating to the investment advisory business were wholly fabricated and completely fictitious.").

181. *See id.* at 46 ("According to the firm's broker-dealer filings, neither the market making nor proprietary trading activities involved the maintenance of customer accounts.").

182. *See* Mark Klock, *Lessons Learned from Bernard Madoff: Why We Should Partially Privatize the Barney Fifes of the SEC*, 42 ARIZ. ST. L.J. 783, 794–95 (2010) ("Apparently, Madoff told [SEC] investigators that he was not required to report investment holdings because he liquidated his investments at the end of each month and held them in cash.").

183. *Id.* at 799 ("One statement claimed 2.5 billion dollars in S&P 100 equities on a particular day being held in one of his funds where Depository Trust Corporation records indicated that only 18 million dollars worth was being held, which is off by a factor of 139.").

184. *See* OIG REPORT, *supra* note 11, at 39–40.

believed these monies were either held in liquid form or in securities positions within BLMIS trading accounts.[185]

Nonetheless, once the news of the Madoff scandal broke, regulators and Investors alike looked to BLMIS (and, in turn, its insurance fund) for reimbursement.[186] The claims forms submitted by Madoff investors expressly state, "The Broker owes me a Credit (Cr.) balance of $_________."[187] In turn, the clawback suits filed by the Trustee quietly and succinctly seek from third parties "customer property"[188] as defined by SIPA;[189] the statute describes such property as "cash and securities . . . at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted."[190] The bankruptcy court's decision interpreted this statutory provision as all assets garnered by the SIPA trustee "on account of customers" to be distributed "pro rata to the extent of a customer's Net Equity."[191] Such a conclusion expands SIPA to include all monies obtained by promise of deposit at the broker-dealer—in essence, the Madoff Corollary to the *Zandford* Dicta.

Consequently, for purposes of the SIPC liquidation, BLMIS is being named as custodian for assets it largely did not have. To this end, it bears noting that at least one court has subordinated the theory that Madoff completely bifurcated his businesses to findings that would result in Investors receiving monies on hand at the broker-dealer; indeed, the same bankruptcy court hearing the clawback suit against Sterling glossed over the distinction

185. *See, e.g.*, DIANA B. HENRIQUES, THE WIZARD OF LIES 256 (2011) ("[T]he cash handed over by investors had been paid out to other investors as bogus investment earnings. [Trustee] Picard had the bank records showing when the cash was withdrawn and by whom . . . .").

186. *See, e.g.*, Berenson & Henriques, *supra* note 87 (quoting the SIPC President as saying, "It is clear that the customers of the Madoff firm need the protections available under federal law."); *see also SIPC President Says $2.6 Billion Will Cover All Legitimate Madoff Claims; Victims Disagree With Formula Used*, SEC. DOCKET (Mar. 27, 2009, 3:32 PM), http://www.securitiesdocket.com/2009/03/27/sipc-president-says-26-billion-will-cover-all-legitimate-madoff-claims-victims-disagree-with-formula-used/ (stating the amount SIPC President believes the Madoff investors should be paid).

187. A copy of the Customer Claim form for the SIPC's liquidation of Bernard L. Madoff Investment Securities is available on the SIPC's website at http://www.sipc.org/cases/docs/Madoff%20Customer%20Web%20Claim%20Form.pdf.

188. Complaint, *supra* note 177, at 10 (noting that the Trustee has authority to seek "customer property" from the Sterling Group, alleged to have been complacent in Madoff's fraud).

189. *See* 15 U.S.C. §78lll(4) (2006) (defining customer property).

190. *Id.*

191. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 124 n.4 (Bankr. S.D.N.Y. 2010).

between Madoff's empires.[192] Regardless, the "non-custody" by BLMIS of Investor monies has been amply documented by securities law experts:

> Madoff concealed his fraud by not appointing an independent third party custodian for the assets of his investment advisory clients as was customary in the industry. The Investment Advisers Act permits any broker-dealer registered under the [Securities Exchange Act] to serve as a qualified custodian of advisory clients' assets. Thus Madoff's brokerage firm was able to serve as a qualified custodian for Madoff's advisory clients' assets. Madoff, however, did not trade on behalf of his advisory clients' accounts. Therefore, *there were no funds or securities flowing in and out of, or held by, these accounts*. An independent, third party custodian would have compared Madoff's fraudulent trading records with the reality of nonexistent client funds and securities and instantly spotted the fraud.[193]

Moreover, all assets traceable to BLMIS are being grouped irrespective of individual Investor accounts (which simply did not exist).[194] On the whole, it would seem that the "investments" by Madoff customers are most readily classifiable as contributions to the enterprise of Bernard Madoff. Indeed, the pitch was often made by middlemen,[195] the monies were pooled and largely kept at banks[196] (i.e., away from the brokerage BLMIS), and the strategy was

192. *Id.* at 127 ("Outwardly, BLMIS functioned as an investment advisor to its customer *and* a custodian of their securities.") (emphasis added). Separately, in December 2011, the Trustee was granted a right to appeal the dismissal of a clawback suit against JP Morgan seeking $19 billion for the bank's alleged role in Madoff's scheme. Rebecca DiLeonardo, *Madoff Trustee Wins Right to Appeal After Dismissal of JP Morgan Suit*, JURIST (Dec. 2, 2011, 12:59 PM), http://jurist.org/paperchase/2011/12/madoff-trustee-wins-right-to-appeal-after-dismissal-of-jp-morgan-suit.php.

193. 6 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD § 19.2 (2d ed. 2011) (emphasis added). Separately, at least one of Madoff's victims has stated that at the time of establishing his account he had been shown by a representative of a feeder fund "a press release that the SEC had made clearing Madoff as a custodian." THE CLUB, *supra* note 32, at 64. Additionally, the broker-dealer as a custodian loophole has been closed. *See SEC Approves Stronger Safeguards to Protect Clients' Assets Controlled by Investment Advisers*, SEC NEWS DIG., Dec. 17, 2009, http://www.sec.gov/news/digest/2009/dig121709.htm (announcing amendments to Investment Advisers Rule 206(4)-2, 17.C.F.R. 275.206(4)-2)).

194. *See supra* notes 180–84 and accompanying text.

195. *See supra* notes 31–32 and accompanying text. Indeed, a 2009 SEC action against "solicitors" for their alleged supplying of Madoff with customers via "feeder funds" was premised upon Madoff having little contact with Investors. *See* Press Release, SEC, SEC Charges Madoff Solicitors and Feeders With Fraud (June 22, 2009), *available at* http://www.sec.gov/news/press/2009/2009-141.htm ("Although Madoff managed all of the [feeder] Funds' assets, many of the Funds' investors had never heard of Madoff before the collapse of his Ponzi scheme . . . .").

196. *See supra* note 39 and accompanying text.

largely accepted without detail, on reputation.[197] Stated otherwise, given the lack of BLMIS account designation and activity, a more supportable reading of SIPA concludes that the Investors were contributing to the capital of BLMIS (or unrelated investment advisory activity), and are thus possibly not eligible to file customer claims with SIPC.[198] In this regard, it bears noting that the Madoff fraud 1) often involved "feeder funds" that seemingly existed solely to introduce Investors to Madoff,[199] and 2) is thought to have been preceded by the fraud at the defunct firm of Avellino and Biennes,[200] which, as a Madoff counterparty in the 1980s, described its customers as "lenders."[201]

If the Investors are nonetheless considered broker-dealer "customers," there are still some bumps in the road to recovery, for the relevant accounts at BLMIS appear to have been in the name of Bernard Madoff (who, incidentally, as sole proprietor of BLMIS, owned all of the firm's capital).[202] Therefore, upon dissection, the government's split empire theory raises substantial questions regarding the kingdom's victimized subjects. For example, if the only Investor funds actually housed at BLMIS were in accounts held in the name of Bernard Madoff, was he a "feeder fund" to his own fraud, thus precluding his SIPC recovery?[203] Additionally, what collateral effect is to be

197. *See* THE CLUB, *supra* note 32, at 193 ("Madoff had an excellent reputation and a track record that was considered the envy of Wall Street."); *id.* at 72 ("I checked with the SEC and Madoff was as good as gold.").

198. *See supra* notes 170–72 and accompanying text; *see also* Complaint, *supra* note 46, at 5 ("In most cases, Madoff set up aggregate, pooled accounts at B[L]MIS for monies raised by . . . solicitors or 'feeders,' leaving it to the feeder to deal with the individual investors by issuing statements, making payments, and the like.").

199. *See, e.g.*, Administrative Complaint at 3, Fairfield Greenwich Advisors LLC, Docket No. 2009-0028 (Mass. Sec. Div. Apr. 1, 2009) (action by the Secretary of the Commonwealth of Massachusetts Securities Division against a Madoff feeder fund) ("The Sentry Funds were over 95 percent invested with Bernard L. Madoff Investment Securities LLC."); Daniel Wise, *Judge Rejects Lawsuit Against 'Sub-Feeder' Fund in Madoff Scandal*, N.Y. L.J., Nov. 1, 2010, at 2 ("Family Management did not place money from its fund directly with Mr. Madoff. Instead, it plowed the money into three alleged feeder funds which then turned over substantial portions of the money under their management to Madoff. . . . Maxam [Fund] has acknowledged that it placed 100 percent of its clients' funds with Mr. Madoff . . . ."). On a related note, in July 2011 the U.S. Bankruptcy Court for the Southern District of New York affirmed the Trustee's denial of claims filed by feeder fund customers, refusing to find the claimants to be "customers" protected by SIPA "no matter how far that word is stretched in service to the equitable ends of SIPA." *See* Yin Wilczek, *Court Rules Madoff Feeder Fund Investors Are Not Eligible for Protection Under SIPA*, 43 Sec. Reg. & L. Rep. (BNA) 1369, 1370 (July 4, 2011).

200. *See supra* notes 65–66 and accompanying text.

201. See HENRIQUES, *supra* note 185, at 98.

202. *See* FINRA REPORT, *supra* note 10, at 46.

203. *See infra* note 231.

accorded settlements wherein banks have acknowledged their serving as the custodian for Investor funds?[204]

Ultimately, the strongest argument for actually putting monies back in the hands of all those angry, victimized "investors" is the broadest possible reading of the *Zandford* Dicta (i.e., finding the securities laws applicable to *any* fraud forming any connection with a brokerage account), thus triggering SIPA and its vehicle for distribution of assets, the SIPC.

C. Policy Choice?

Regardless, the question of SIPA applicability was resolutely resolved within days of Madoff's arrest.[205] The question of the SEC's involvement with the liquidation of BLMIS was decided in favor of a private trustee.[206] The more difficult question of the depth of SIPC coverage has been resolved for the time being—albeit obliquely—by cases weighing the proper method of calculating investor losses attributable to the Madoff scheme. Specifically, to allow investors making SIPC claims the full value of the account listed on a fraudulent statement would create a tab in excess of $60 billion (i.e., a total that would exhaust the insurance fund and the expected amount of recovered funds several times over);[207] moreover, such payouts, by validating an allocation of scheme assets created by Madoff and/or his co-conspirators, would arguably serve to validate a preferential schedule prepared by an admitted fraudster.[208] Accordingly, the Trustee and others have termed such a category of investors "net winners" and excluded them from the reimbursements.[209]

Conversely, limiting the definition of recoverable claims to those filed by customers who withdrew less cash than they deposited ("net losers") would result in recoverable claims totaling approximately $20 billion, a goal within

204. *See, e.g.*, *HSBC Settles Madoff Claims for $62.5 Million*, N.Y. TIMES, June 8, 2011, at B5 ("HSBC had acted as custodian and provided administration and other services" for an Irish fund that invested with BLMIS.).

205. *See supra* note 184.

206. The SEC's original December 11, 2008 filing seeking receivership of all BLMIS assets was ultimately subsumed into the Trustee's SIPC proceeding. *See* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 124 n.3 (Bankr. S.D.N.Y. 2010).

207. Noeleen G. Walder, *Madoff Investors Urge Circuit to Reject Trustee's Loss Estimates*, N.Y. L.J., Mar. 4, 2011, at 1 (describing the appellate hearing before the Second Circuit Court of Appeals on *In re Bernard Madoff Investment Securities*, 424 B.R. 122).

208. *Id.* (quoting a lawyer for the Trustee as stating, "This [the Madoff scam] is a Ponzi scheme. This is a zero sum game . . . .").

209. *Id.*

reach in light of the Trustee's recovery of approximately $10 billion as of March 2011.[210]

In ruling in favor of the attainable, Judge Lifland stated the following in the Bankruptcy Decision:

> Although the securities that Madoff allegedly purchased were identifiable in name, the securities positions reflected on customer account statements were artificially constructed. By backdating trades to produce predetermined, favorable returns, Madoff . . . essentially pulled the fictitious amounts from thin air. The resulting securities positions on customers' November 30th Statements were therefore entirely divorced from the uncertainty and risk of actual market trading. In fact, at certain times, Madoff customers . . . held at least one imaginary security. . . . It would be simply absurd to credit the fraud and legitimize the phantom world created by Madoff . . . .[211]

Thus, with SIPC—in the first and only instance[212]—insuring against the custodial risk attending customer deposits with registered broker-dealers,[213] whether the Madoff broker-dealer also served as a registered investment adviser for all the years in question is, at best, a distraction, and, at worst, potentially fatal to coverage. The need for this coverage was heightened by the

210. Critics of the "net losers" approach have opined that approximately $25 billion in claims will never be allowed because the potential claimants are defendants in suits alleging their complicity in the scheme. *See id.* (quoting Helen Davis Chaitman of the law firm of Becker & Poliakoff). As of June 2011, the Trustee's Clawback Suits collectively sought almost $80 billion from various parties. *See* Destefano, *Madoff Damages*, *supra* note 74 ("Since 2009, Picard has filed lawsuits which now total close to $80 billion."); *see also supra* note 177 (noting the court's reduction of claims and alleged recoveries in September 2011).

211. *In re Bernard Madoff Investment Securities*, 424 B.R. at 139–40; *see also In re* New Times Secs. Servs. Inc., 371 F.3d 68, 88 (2d Cir. 2004) (finding the district court's calculation of each SIPC claimant's net equity "irrational and unworkable" because it had relied on account statements describing positions in fictitious mutual funds).

212. *See* Sec. Investor Prot. Corp. v. Barbour, 421 U.S. 412, 425 (1975) (denying a private cause of action under SIPA to redress securities fraud by stating, "Instead of enlisting the aid of investors in achieving that purpose, Congress imposed upon the SEC, the exchanges, and the self-regulatory organizations the obligation to report to the SIPC any situation that might call for its intervention.").

213. Illustrating the importance of this protection, the web site for the broker-dealer unit of Wells Fargo states:

> Wells Fargo Advisors is a member of the Securities Investor Protection Corporation (SIPC), a nonprofit, congressionally chartered membership corporation created in 1970. SIPC protects clients against the *custodial risk* of a member investment firm becoming insolvent by replacing missing securities and cash up to $500,000, including up to $250,000 in cash per client in accordance with SIPC rules.

Account Protection, WELLS FARGO, https://www.wellsfargoadvisors.com/financial-services/account-services/sipc-protection.htm (last visited Nov. 19, 2011).

times and concomitantly guaranteed by SIPC's President within the same month that news of the Madoff scandal broke.[214]

Overall, when one considers the series of disconnects in the Madoff case—between Investors and any purchases, between BLMIS funds and any Investor account, between BLMIS activities and BLMIS profits—it is clear that the SEC and SIPC made policy choices allowing investors with an owner of a broker-dealer to seek third party reimbursements for promised, private activity. In short, some vagaries in the federal laws were used to make good on a scam perpetrated by a mascot on behalf of his fans. Perhaps such strained remedial determinations were the best of available choices under the circumstances.[215] The point to be made is that the determinations sound foremost as policy choices, strengthened by the coloring of theft as securities fraud, yet of surprisingly little precedential value.[216]

Undoubtedly, in the future, the system can be better prepared.

214. *See* Joe Nocera, *Madoff Victims: The Lawyers Respond*, N.Y. TIMES EXECUTIVE SUITE BLOG (July 7, 2009, 7:59 PM), http://executivesuite.blogs.nytimes.com/2009/07/07/madoff-victims-the-lawyers-respond/ (relaying the arguments of attorneys at the firm of Lax & Neville, who had unsuccessfully argued that Madoff customers—even if labeled by some as "net winners"—were entitled to reimbursements of the amounts represented in their monthly statements). The statement of one Lax & Neville attorney describes relevant SIPC representations to the public in December 2008:

> SIPC's general counsel, Josephine Wang, confirmed [the net equity] approach on December 16, 2008, just five days after the Madoff scandal broke. And, in fact, SIPC's president, Stephen Harbeck, assured a federal bankruptcy court, in another massive Ponzi scheme, that customers would receive securities up to $500,000, including appreciation, even if the securities at issue were never purchased.

Id.

215. It bears noting that application of solely the Investment Advisers Act—or solely any one of the securities laws to all of Madoff's bizarrely brazen activities—would have been difficult. *See* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 127 (Bankr. S.D.N.Y. 2010) ("BLMIS began to offer investment advisory services as early as the 1960s, yet never truly acted as a legitimate investment adviser to its customers.").

216. In requesting in June 2011 that SIPC reimburse Stanford Ponzi scheme customers, the SEC concluded that "the many companies controlled and directly or indirectly owned by Stanford 'were operated in a highly interconnected fashion, with a core objective of selling' the CDs" at the center of the scam. Press Release, SEC, SEC Concludes That Certain Stanford Ponzi Scheme Investors Are Entitled to Protections of SIPA (June 15, 2011), *available at* www.sec.gov/news/press/2011/2011-129.htm. Astonishingly, in the ensuing six months SIPC refused to make a decision on coverage, prompting the threat of both an SEC lawsuit and Congressional hearings while triggering journalistic suspicion. *See* Loren Steffy, *Technicality Picks up Where Lossess Left Off*, HOUS. CHRON., Dec. 4, 2011, at B1 ("After all, SIPC paid investors for losses in Bernard Madoff's fraud case, and it has rushed in to assume losses in the bankruptcy of the commodities firm MF Global.").

CONCLUSION: ON MASCOTS AND MASQUERADES

Ponzi schemes have become the standard by which financial frauds are measured.[217] Indeed, the words "Madoff mess" have become part and parcel of the American legal lexicon.[218] One is tempted to rush to support any imprisonment, repayment, or interpretation that brings the $30 billion nightmare to an end.

The nightmare started with the unmasking of a masquerade, at the worst possible time. In late 2008, the stock market was plummeting,[219] and the government (after an initial legislative defeat) had passed the first bailout.[220] The mood of the nation in the next few months was tragically tense,[221] and the SEC was publicly labeled a large part of the cause.[222] Against this backdrop, regulators and related entities rushed to calm the investing public, at times espousing remedies that were perhaps not legally feasible.[223] Complicating matters was the fact that the primary architect of arguably the world's most successful financial ruse ever was refusing to provide details; in short, Bernard Madoff confessed to an undescribed fraud that is still scandalously short on facts. Indeed, the resulting partial reimbursement itself would not have been possible had the fraudster Madoff not owned and operated a brokerage house.

But, upon analysis, the vagaries decided in favor of the SEC and SIPC may have simply stacked too high. The Commission, grossly embarrassed by the

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217. *See* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 14–15 (2010) ("[Subprime lending companies] had the essential feature of a Ponzi scheme: To maintain the fiction that they were profitable enterprises, they needed more and more capital to create more and more subprime loans.").

218. *See* Pamela A. MacLean, *Next Wave in Madoff Mess: Tax Trouble*, NAT'L L.J., Feb. 16, 2009, at 6 (highlighting the tax problems for Madoff investors who unwittingly paid taxes on fictitious profits). CNNMoney online has an entire section devoted to Madoff coverage called Special Report: Madoff Mess. *Special Report: Madoff Mess*, CNNMONEY, http://money.cnn.com/news/specials/madoff/ (last visited Nov. 19, 2011); Nicholas Varchaver et al., *Madoff's Mother Tangled with the Feds*, CNNMONEY (Jan. 16, 2009, 3:43 PM), http://money.cnn.com/2009/01/16/magazines/fortune/madoff_mother.fortune (describing the possibility that Madoff's mother owned a brokerage closed by regulators).

219. The Dow Jones Industrial Average sank 2,690 points (24 %) between September 1, 2008 and December 1, 2008. *See Historical Prices: Dow Jones Industrial Average*, YAHOO! FINANCE, http://finance.yahoo.com/q/hp?s=%5EDJI&a=08&b=1&c=2008&d=11&e=1&f=2008&g=d (last visited Nov. 29, 2011).

220. *See generally* J. Scott Colesanti, *Laws, Sausages & Bailouts: Testing the Populist View of the Causes for the Economic Crisis,* 4 BROOK. J. CORP. FIN. & COM. L. 175, 182 (2010).

221. *See* Adam Zagorin & Michael Weisskopf, *The Inside Story on the Breakdown at the SEC*, TIME, Mar. 9, 2009, at 34 (calling the extant economy "the worst financial crisis since the Great Depression").

222. *Id.* (noting that Senator John McCain had "publicly called for the firing of the SEC boss" in 2008).

223. *See generally* Dennis K. Berman, *Debating the Legality of the Bailout*, WALL ST. J., Dec. 7, 2010, at C1.

Madoff fraud,[224] may have utilized some embarrassing loopholes to calm the masses.[225] To wit, the "securities fraud" charge may have been a bit inappropriate, particularly where no securities were traded, the monies were often pooled and occasionally simply looted, and the scheme itself was never characterized as a security.[226] To paraphrase the Bankruptcy Decision, the people who are now receiving reimbursements "were never exposed to the uncertainties of price fluctuation" and their account statements "bore no relation to the United States securities markets at any time."[227] Stated simply, if the SEC had left Rule 10b-5 out of the case, it ran the risk of a Ponzi scheme without securities transactions (but nominally housed at a broker-dealer) coming under heightened scrutiny when juxtaposed with the SIPA; accordingly (and, perhaps justifiably) the broader policy road was taken.

Thus, while the Madoff disaster and cleanup may have most readily exposed inadequate SIPC funding[228] and lapses in SEC oversight,[229] the events have also served to highlight the serious issues of the limits to "securities fraud" and the definition of reimbursable customers. Whereas the charging of the strongest weapon in the SEC arsenal evidenced an election of remedies,[230] the ensuing use of SIPC's alternative scheme of bankruptcy seems even more suspect because, for a majority of the monies propping up the Madoff scheme, no brokerage account was utilized. It bears noting that in the case of the contemporaneous Stanford Ponzi scheme, the government itself initially and

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224. *See, e.g.*, Joe Klein, *Who's Afraid of Reforming Wall Street*, TIME, Mar. 14, 2011, at 27 ("The SEC wasn't even able to spot the broad-daylight highway robbery committed by Bernard Madoff.").

225. *See generally* Deborah L. Cohen, *Wetting Their Whistles: The SEC is Giving Whistle-Blower Protection One Last Lick*, A.B.A. J., Mar. 2011, at 14 (quoting a principal of the Employment Law Group of Washington, D.C. as saying, "After the Bernard Madoff scandal broke, the SEC had a lot of egg on its face . . . .").

226. *See, e.g.*, Press Release, SEC, SEC Obtains Emergency Asset Freeze in Diamond-Themed Ponzi Scheme (Nov. 23, 2010), *available at* http://www.sec.gov/news/press/2010/2010-231.htm (discussing an emergency court order against a Ponzi scheme operator accused of selling bank notes as part of a "Diamond Program," such notes constituting "unregistered securities").

227. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 128 (Bankr. S.D.N.Y. 2010); *see also* Complaint, *supra* note 46, at 2, 7 (alleging that one BLMIS employee withdrew almost $10 million in fictional profits tied to Investor accounts).

228. *See* Diana Henriques, *Victims of Madoff Seek Claims Overhaul*, N.Y. TIMES, June 8, 2009, at B1 (detailing that, at the time, 8,800 claims had been filed, trending towards a bill exceeding $4.4 billion—"a sum the taxpayers would have to cover if SIPC could not").

229. *See supra* notes 47–48 and accompanying text.

230. *See, e.g.*, Press Release, SEC, SEC Halts $47 Million Investment Fraud at Utah-Based Payday Loan Companies (Mar. 28, 2011), *available at* http://www.sec.gov/news/press/2011/2011-73.htm (describing the application of § 206 of the Investment Advisers Act to a Ponzi scheme utilizing a single, pooled bank account and allegedly harming to at least 120 investors).

unapologetically denied SIPC—and FDIC—coverage to the fraud's victims.[231] At best, summing up the criminal activities of Madoff and his cohorts as "securities fraud"—and, concurrently, the victimized as broker-dealer "customers"—was politically expedient. The scrutiny of such forced logic becomes vital in light of the fact that some courts appear willing to point out that the evidence fails to support a "securities" fraud of any ilk.[232] In short, no one wishes to see a felon go free because of a prosecutor's poor choice of weapons; further, no victim should have to rest his faith in a recovery on unpredictably liberalized views of dated rules and laws.

A Solution

The SEC has confessed that the rules attending custody by an investment adviser needed "fine tuning." Within a year of the Madoff revelations, the Commission Chairman had announced controls addressing the "situations [where] there is heightened opportunity for an adviser to misappropriate a client's assets and convert those assets to their own personal use."[233] Further,

231. *See FDIC and SIPC Issues Regarding Stanford International Bank CDs*, STANFORD FINANCIAL GROUP RECEIVERSHIP (Aug. 17, 2009), http://www.stanfordfinancialreceivership.com/documents/FDIC_and_SIPC_Issues_Regarding_Stanford_International_Bank_CDs.pdf ("SIPC protects only the *custodial* function of an insolvent member firm. Thus, SIPC only provides protection for securities and cash that are missing from a customer's account at a SIPC member firm."). Significantly, in July 2011, SIPC announced that it would rule in September on the SEC's new recommendation that Stanford victims who had purchased certificates of deposit through Stanford's broker-dealer were entitled to customer status under the SIPA. *See SIPC to Announce Decision on Liquidation of Stanford's Brokerage in Mid-September*, 43 Sec. Reg. & L. Rep. (BNA) 1408 (July 11, 2011).

232. *See, e.g.*, *Claims Against Madoff Feeder Funds, Gatekeepers May Proceed, Court Concludes*, 42 Sec. Reg. & L. Rep. (BNA) 1587, 1587 (Aug. 2010) (relating the refusal of the U.S. District Court for the Southern District of New York, hearing *Anwar v. Fairfield Greenwich Ltd.*, to dismiss the complaint on grounds of preemption by SLUSA and holding that "stretching SLUSA to cover this chain of investment—from Plaintiff's initial investment in the Funds, the Funds' reinvestment with Madoff, Madoff's supposed purchases of covered securities, to Madoff's sale of those securities and purchases of Treasury bills—snaps even the most flexible rubber band."). The court thus allowed the case to proceed under a theory of negligence, as opposed to securities fraud. *But see* Barron v. Igolnikov, No. 09 Civ. 4471(TPG), 2010 WL 882890, at *5 (S.D.N.Y. Mar. 10, 2010) (finding, for purposes of SLUSA, that Madoff's actions constituted misrepresentations and omissions, and that claims premised upon failures to buy/sell securities were covered by the Securities Exchange Act); *see also* Bakus v. Conn. Cmty. Bank, No. 3:09-CV-1256, 2009 WL 5184360, at *5 (D. Conn. Dec. 23, 2009) ("[T]he individual securities fraudulently represented to be bought, sold, and held . . . are covered securities."). *Cf.* Complaint, *supra* note 9, at 7–8 (alleging that Madoff's actions constituted "devices, schemes and artifices to defraud" but not basing offenses on alleged misrepresentations).

233. Mary L. Schapiro, Chairman, SEC, Statement at SEC Open Meeting on Strengthening Safeguards to Protect Clients' Assets Controlled by Investment Advisers (Dec. 16, 2009), *available at* http://www.sec.gov/news/speech/2009/spch121609mls-custody.htm ("The rules we

the landmark, omnibus Dodd-Frank Reform Act of 2010[234] tacitly identified the primary reason for the Madoff fraud where it granted the SEC authority to examine the records of any custodian named by an investment adviser.[235]

Additional changes are needed. To prevent the ad hoc decision-making and inconsistencies described herein, the "in connection with" requirement of Commission Rule 10b-5 needs to be legislatively removed by the SEC for certain cases. Such foresight can only rehabilitate the tarnished image of the Commission[236] and a stock market that has yet to win back the confidence of the retail investor.[237] The SEC routinely lowers its burden of proof by formal decree. For example, in the landmark case of *Chiarella v. United States*,[238] the SEC's "parity of information" theory of insider trading liability was firmly rejected by the Supreme Court.[239] The Commission would thus be thereafter forced to prove that a defendant who was not an employee or otherwise an insider of the subject company had obtained the inside information by improper means. In response to this limitation by the high Court, the SEC simply adopted Rule 14e-3,[240] which stands till today as the legal authority for actions (both civil and criminal) against "outside" defendants improperly obtaining information about a tender offer.[241]

Similarly, after losing in its bid to apply the problematic misappropriation theory to a stockbroker thrice-removed from a source of inside information

are considering grow out of the Madoff Ponzi scheme, and other frauds in which investor assets were misappropriated by investment advisers.").

234. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

235. Dodd-Frank Wall Street Reform and Consumer Protection Act § 929Q(a)(2), 15 U.S.C. § 80a-30(b) (2006); *see also* Joe Lustig, *Investment Advisers Should Expect More Onsite Exams in Future, Official Says*, 43 Sec. Reg. & L. Rep. (BNA) 588 (Mar. 21, 2011) (discussing the Commission's new, express confirmation asset authority, which extends to "entities subject to federal financial regulation, such as banks").

236. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT, at xxi (2011) ("Days before the collapse of Bear Stearns in March 2008, SEC Chairman Christopher Cox expressed 'comfort about the capital cushions' at the big investment banks.").

237. *See, e.g.*, Sree Vidya Bhaktavatsalam, *Mutual Fund Withdrawals A Record As Investors Flee*, BLOOMBERG (Oct. 9, 2008, 9:27 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTB_zifIPxIM (describing $52 billion in withdrawals from mutual funds by investors in the first week of October 2008).

238. 445 U.S. 222 (1980).

239. *Id.* at 228–31, 233–34.

240. 17 C.F.R. § 240.14e-3 (2010). Rule 14e-3 expressly extends Rule 10b-5's "fraudulent, deceptive or manipulative act or practice" language to parties in possession of material information relating to a third party's tender offer when such information is known to be nonpublic or emanated from certain enumerated parties.

241. *Id.*

(the *Chestman* case of 1991),[242] the SEC utilized its rulemaking authority to adopt a supplement to Rule 10b-5 that expressly allows a breach of the husband-wife duty of confidentiality to serve as the premise for an insider trading case.[243]

Likewise, for special situations like the Madoff case, the SEC should lower its pleading burden. Namely, a fraud tied to a reputation (of either a brokerage or its owner) should be just as reachable as one tied to a brokerage account actually housing promised trades. Such special circumstances could focus on situations where the totality of events indicates that the fraud would not have been possible without the perceived imprimatur of stock market success and/or the utilization of the resources of a registered industry entity—even if limited to use of a logo. Such remedial rulemaking would not only provide certainty and forewarning but also reclaim from Congress and other federal agencies the policy-setting authority intended to be reposed within the SEC since its inception.

* * * *

Another Bailout quietly occurred in recent years—the reimbursement of (a percentage of) outraged, wealthy investors who were to varying degrees duped. This government largesse proceeded on a largely unchallenged conclusion that such investors were protected by Rule 10b-5 (the SEC's harshest weapon); the alternative would have been perceived as slavish devotion to technicalities that, given the atmosphere in the fall of 2008, likely would have surrounded Capitol Hill with citizens armed with torches and pitchforks.

The Madoff debacle has been blamed for so many past omissions that it is easy to forget what it omits in the future: the likelihood that investors will continue to trust the stock market and its chief policeman.[244] To be sure, investment, investment clubs, and other alternatives to the stock market are becoming the norm rather than the exception.[245] As Federal Reserve Chairman Ben Bernanke opined, "We have to pay attention to the lessons of history. If you look at the history of financial crises, it shows that an aggressive and

242. United States v. Chestman, 947 F.2d 551, 555, 571 (2d Cir. 1991) (en banc) (finding the defendant not guilty of insider trading premised upon a breach of a duty of confidentiality between husband and wife).

243. 17 C.F.R. § 240.10b5-2 (2010).

244. *See, e.g.*, Matthew Saltmarsh, *Wealthy Turn to Social Media for Investment Help*, N.Y. TIMES (Apr. 5, 2011), http://www.nytimes.com/2011/04/06/technology/06bhive.html?pagewanted=all ("The Bernard Madoff scandal shook up many wealthy investors, pushing them toward different forms of financial advice and the safety of being next to investors who are part of their community, in this case online.").

245. See Felix Salmon, *Wall Street's Dead End*, N.Y. TIMES, Feb. 14, 2011, at A27 ("Today, however, stock markets, once the bedrock of American capitalism, are slowly becoming a noisy sideshow that churns out increasingly meager returns.").

creative response is the best way to ensure minimal damage to the economy."[246] The proactive fine-tuning described herein may describe an aggressive response to a uniquely mammoth financial crime. But such remedy would signal to the public that, although some legal shortcuts might have been taken in recent times, the system has progressed. Such agency legislation would perhaps restore faith among those who have grown tired of the masquerades. Moreover, given the ever-growing expansion and complexity of investment, it would very likely prevent the chaos that will result the next time victims scurry for stressed insurance fund reimbursement of dollars that were blindly entrusted by Wall Street's fans to the industry's mascot.

246. *10 Questions: Ben Bernanke Will Now Take Your Questions*, TIME, Dec. 27, 2010, at 14.