13038.

[8]Investment Adviser Marketing, 86 Fed. Reg. at 13038 n. 164.

[9]A disqualifying event is any of the following events that occurred within 10 years prior to the person disseminating an endorsement or testimonial: (i) A conviction by a court of competent jurisdiction within the United States of any felony or misdemeanor involving conduct described in paragraph (2)(A) through (D) of section 203(e) of the Act; (ii) A conviction by a court of competent jurisdiction within the United States of engaging in any of the conduct specified in paragraphs (1), (5), or (6) of section 203(e) of the Act; (iii) The entry of any final order by any entity described in paragraph (9) of section 203(e) of the Act, or by the U.S. Commodity Futures Trading Commission or a self-regulatory organization (as defined in the Form ADV Glossary of Terms), of the type described in paragraph (9) of section 203(e) of the Act; (iv) The entry of an order, judgment or decree described in paragraph (4) of section 203(e) of the Act, and still in effect, by any court of competent jurisdiction within the United States; and (v) A Commission order that a person cease and desist from committing or causing a violation or future violation of: (A) Any scienter-based anti-fraud provision of the Federal securities laws, including without limitation section 17(a)(1) of the Securities Act of 1933 (15 U.S.C.A. 77q(a)(1)), section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C.A. 78j(b)) and 17 C.F.R. 240.10b-5, section 15(c)(1) of the Securities Exchange Act of 1934 (15 U.S.C.A. 78o(c)(1)), and section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C.A. 80b-6(1)), or any other rule or regulation thereunder; or (B) Section 5 of the Securities Act of 1933 (15 U.S.C.A. 77e). A disqualifying event does not include an event described in paragraphs (e)(4)(i) through (v) of the above with respect to a person that is also subject to: (A) An order pursuant to section 9(c) of the Investment Company Act of 1940 (15 U.S.C.A. 80a-3) with respect to such event; or (B) A Commission opinion or order with respect to such event that is not a disqualifying Commission action; provided that for each applicable type of order or opinion described in paragraphs (e)(4)(vi)(A) and (B) of this section: (1) The person is in compliance with the terms of the order or opinion, including, but not limited to, the payment of disgorgement, prejudgment interest, civil or administrative penalties, and fines; and (2) For a period of 10 years following the date of each order or opinion, the advertisement containing the testimonial or endorsement must include a statement that the person providing the testimonial or endorsement is subject to a Commission order or opinion regarding one or more disciplinary action(s), and include the order or opinion or a link to the order or opinion on the Commission's website.

[10] Investment Adviser Marketing, 86 Fed. Reg. at 13060 (stating "we disagree with some commenters who requested that we grandfather all ongoing solicitation arrangements entered into prior to the final rule's effective date").

SECOND CIRCUIT: MADOFF PONZI SCHEME CUSTOMERS DID NOT RECEIVE FICTITIOUS PROFIT PAYMENTS "FOR VALUE"

By Dan T. Moss and Mark G. Douglas

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In the latest chapter of more than a decade of litigation involving efforts to recover fictitious profits paid to certain customers of Bernard Madoff's defunct brokerage firm as part of the largest Ponzi scheme in history, the U.S. Court of Appeals for the Second Circuit held in *In re Bernard L. Madoff Investment Securities LLC*[1] ("*Madoff*"), that the customers did not have a defense to avoidance and recovery because they received the payments "for value." The Second Circuit also ruled that the trustee overseeing the brokerage firm's liquidation properly determined the amount subject to recovery despite calculating the defendants' liability by netting the amounts they received against what they invested since the firm's inception.

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Good-Faith Defense to Avoidance of Fraudulent Transfers

Section 548(a)(1) of the Bankruptcy Code authorizes a bankruptcy trustee to avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor "on or within 2 years before the date of the filing of the petition" if: (i) the transfer was made, or the obligation was incurred, "with actual intent to hinder, delay, or defraud" any creditor; or (ii) the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, among other things, insolvent, undercapitalized, or unable to pay its debts as such debts matured.

Section 548(c) provides a defense to avoidance of a fraudulent transfer for a "good faith" transferee or obligee who gives "value" in exchange for a transfer or obligation:

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title [dealing with a trustee's power to avoid, respectively, transfers that are voidable under state law, statutory liens, and preferential transfers], a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.[2]

Section 548(d)(2)(A) states that "value" for the purposes of section 548 "means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."

"Good faith" is not defined by the Bankruptcy Code. In determining whether it exists, some courts have applied a two-part analysis, examining: (i) whether the transferee was on inquiry notice of suspicious facts amounting to "red flags"; and (ii) if so, whether the transferee reasonably followed up with due diligence to determine whether a transaction may not have been bona fide. *See, e.g.*, *In re American Housing Foundation*[3]; *In re Bayou Group, LLC*.[4]

Stockbroker Liquidations Under SIPA

Congress enacted the Securities Investor Protection Act, 15 U.S.C.A. §§ 78aaa *et seq.* ("SIPA"), in 1970 to deal with a crisis in customer and investor confidence and the prospect that capital markets might fail altogether after overexpansion in the securities brokerage industry led to a wave of failed brokers. The law was substantially revamped in 1978 in conjunction with the enactment of the Bankruptcy Code.

A SIPA proceeding is commenced when the Securities Investor Protection Corporation ("SIPC") files an application for a protective decree regarding one of its member broker-dealers in a federal district court. If the district court issues the decree, it appoints a trustee to oversee the broker-dealer's liquidation and refers the case to the bankruptcy court.

SIPA affords limited financial protection to the customers of registered broker-dealers. A "customer" is any person who has a claim:

> on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer.[5]

The term also includes "any person who has deposited cash with the debtor for the purpose of purchasing securities."

SIPA liquidations generally involve customer claims and the claims of general unsecured creditors, such as vendors or judgment creditors. Customer claims are satisfied out of a customer estate (a fund consisting of customer-related assets, such as securi-

ties and cash on deposit), while general unsecured claims are paid from the general estate (any remaining assets). The value of a customer's account, or its "net equity," is the measure of its SIPA customer claim.[6] "Net equity" is the total value of cash and securities owed to the customer as of the petition date, less the total value of cash and securities owed by the customer to the debtor as of the petition date.[7]

SIPC, a nonprofit membership corporation funded by its member securities broker-dealers, advances funds to the trustee as necessary to satisfy customer claims but limits them to $500,000 per customer, of which no more than $250,000 may be based on a customer claim for cash. SIPC is subrogated to customer claims paid to the extent of such advances. Those advances are repaid from funds in the general estate prior to payments on account of general unsecured claims.

If property in the customer estate is not sufficient to pay customer net equity claims in full, "the [SIPA] trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of [the Bankruptcy Code]."[8]

As noted, the bankruptcy court presides over a SIPA case, and the case proceeds very much like a chapter 7 liquidation, with certain exceptions. SIPA expressly provides that "*[t]o the extent consistent with the provisions of this chapter*, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11."[9]

This means, for example, that the automatic stay precludes the continuation of most collection efforts against the debtor or its property but not the exercise of the contractual rights of a qualifying entity (*e.g.*, a stockbroker or a financial participant) under a financial or securities contract or a repurchase agreement.[10] Similarly, the SIPA trustee has substantially all of a bankruptcy trustee's powers, including the avoidance powers. However, neither a SIPA trustee nor a bankruptcy trustee may avoid certain transfers made by, to, or for the benefit of stockbrokers, repurchase agreement participants, swap agreement participants, and certain other entities, unless the transfer was made with actual intent to hinder, delay, or defraud creditors in accordance with section 548(a)(1)(A).[11]

Madoff

Bernard L. Madoff Investment Securities LLC ("MIS") was the brokerage firm that carried out Bernard Madoff's infamous Ponzi scheme by collecting customer funds that it never invested and making distributions of principal and fictitious "profits" to old customers with funds it received from new customers. After the scheme collapsed in December 2008, the U.S. District Court for the Southern District of New York issued a protective decree for MIS under SIPA.

Because the customer property held by MIS was inadequate to pay customer net equity claims, the SIPA trustee sought to recover funds that would have been customer property had MIS not transferred them to others. Certain customers had net equity claims, because they had withdrawn less than the full amount of their investments from their MIS accounts before entry of the protective decree. Other customers had no net equity claims, because they withdrew more money from their accounts than they had deposited. These customers (collectively, "Madoff Defendants") received not only a return of their principal investment but also the fictitious "profits" that were actually other customers' money.

In 2010, the SIPA trustee sued the Madoff Defendants in the bankruptcy court seeking to avoid and recover the profits as actual and constructive fraudu-

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lent transfers under sections 548(a)(1)(A) and 548(a)(1)(B) of the Bankruptcy Code. The Madoff Defendants did not dispute that MIS made the payments with actual intent to hinder, delay, or defraud creditors. Instead, they argued that the trustee could not recover the transfers because: (i) they were protected from avoidance under section 546(e) as settlement payments or transfers made in connection with a securities contract; and (ii) the Madoff Defendants had a defense to avoidance under section 548(c) because they received the payments in exchange "for value."

That litigation and hundreds of similar actions were later consolidated in the U.S. District Court for the Southern District of New York. Largely adopting the reasoning in a case involving MIS and other customers who received fictitious profits (*Securities Investor Protection Corp. v. Bernard L. Madoff Inv. Securities LLC*,[12] ("*Greiff*")), the district court in *Madoff* held that: (i) the customer agreements between MIS and the Madoff Defendants qualified as securities contracts, and the payments were therefore safe harbored from avoidance as constructive fraudulent transfers by section 546(e) as "settlement payments," even though MIS did not actually complete the securities transactions because it never invested the funds; and (ii) the Madoff Defendants did not have a section 548(c) defense to the trustee's actual fraudulent transfer claims because they did not take the transfers in exchange "for value." The court also held that section 548(a)(1) did not prohibit the trustee from considering transfers made more than two years prior to the SIPA petition date in calculating the amount of money subject to recovery.

In *Greiff*, a different district court rejected customers' argument that the fictitious positions listed on their account statements evidenced "securities entitlements" under applicable law (the New York Uniform Commercial Code ("NYUCC")) or any other "right to payment" that would qualify as "value." According to the court, the section 548(c) defense applies only when there is a "commensurability of consideration"—*i.e.*, where payments to an investor contesting avoidance are "offset by an equivalent benefit to the estate."[13] It also noted that "every circuit court to address this issue has concluded that an investor's profits from a Ponzi scheme, whether paper profits or actual transfers, are not 'for value.' "[14]

The *Greiff* district court also rejected the customers' argument that they were entitled to retain the transfers because they were creditors rather than equity investors. It concluded that "the general rule that investors in a Ponzi scheme d[o] not receive their profits 'for value' " also applies to "this unusual kind of 'creditor,' whose claims to profits depend upon enforcing fraudulent representations."[15] Finally, the *Greiff* district court reasoned that, even if the customers had enforceable claims for the amounts reported on their brokerage statements, a conclusion that satisfaction of those debts gave "value" to MIS would conflict with SIPA's priority scheme "by equating net equity and general creditor claims."

After denying the Madoff Defendants' motion for an interlocutory appeal, the *Madoff* district court remanded the case to the bankruptcy court, where both MIS and the Madoff Defendants sought summary judgment. In its report, the bankruptcy court recommended to the district court that summary judgment be entered in favor of the trustee.

The Madoff Defendants objected to the recommendation. They reiterated their original arguments regarding section 548(c), stating that a supervening Second Circuit ruling in *Picard v. Ida Fishman Revocable Trust a.k.a. In re Bernard L. Madoff Inv. Securities LLC*[16] ("*Fishman*"), compelled the conclusion that the transfers were "for value." The Madoff Defendants also argued that the U.S. Supreme Court's ruling in *California Public Employees' Retirement System v. ANZ Securities, Inc.*

("*ANZ*"),[17] clarified that permitting the trustee to recover the transfers would violate section 548(a)(1)'s two-year limitation period.

In *Fishman*, the Second Circuit affirmed the district court's ruling in *Greiff* dismissing the trustee's constructive fraudulent transfer claims. According to the Madoff Defendants, *Fishman* established a new rule—*i.e.*, that courts must rely on the Bankruptcy Code alone, as distinguished from SIPA, to determine whether transfers are shielded from recovery by an affirmative defense. The *Madoff* district court rejected this argument, concluding that *Fishman*, which addressed whether the transfers were settlement payments for purposes of section 546(e), did not decide what constitutes "for value" under section 548(c) and the two concepts are distinct.

In *ANZ*, the Supreme Court held that a statutory provision limiting claims under federal securities laws to those brought within three years of the securities offering is a "statute of repose," rather than a statute of limitation, meaning that the three-year period cannot be equitably tolled. According to the *Madoff* district court, *ANZ* did not require it to reconsider its earlier conclusion that the trustee's actual fraudulent transfer claims did not violate the two-year limitation in section 548(a)(1) because its previous decision approving the trustee's calculation of the amount that could be recovered from the Madoff Defendants "did not turn on whether § 548(a) was a statute of repose or a statute of limitation" and contained "no discussion of equitable tolling."

The district court adopted the bankruptcy court's recommendation and granted summary judgment in favor of the trustee. The Madoff Defendants appealed to the Second Circuit.

The Second Circuit's Ruling

The Second Circuit affirmed the district court's ruling.

The Madoff Defendants argued that they received the transfers "for value" because: (i) the transfers satisfied a property right to payment of "profits" created when MIS fabricated account statements that appeared to show customers' investments were profitable; and (ii) the transfers discharged MIS' liability on claims based on the Madoff Defendants' contract rights. Writing for the three-judge panel, Circuit Judge Robert D. Sack rejected these arguments.

According to Judge Sack, the Second Circuit did not hold in *Fishman* that customer account statements created property rights in the form of "securities entitlements" under the NYUCC but, instead, that transfers to customers qualified for the section 546(e) safe harbor as settlement payments. Even if the account statements created such entitlements under the NYUCC, Judge Sack explained, they did not give the Madoff Defendants property rights to fictitious profits from fictitious trading.

The Second Circuit also rejected the Madoff Defendants' argument that they gave value for the transfers in the form of a discharge of their contract rights under federal securities laws, which allow an innocent party to a securities contract procured by fraud to either void or enforce the contract. A finding that the transfers were "for value," Judge Sack noted, would conflict with SIPA, which prioritizes customers over general creditors and only selectively incorporates the Bankruptcy Code to the extent not inconsistent with SIPA's provisions.

A SIPA trustee can invoke the Bankruptcy Code's avoidance provisions to recover customer property, Judge Sack wrote, "[b]ut whether a transferee can invoke the 'for value' defense—exactly as that defense applies in bankruptcy, *i.e.*, to transfers that satisfy debt or discharge liability on a claim—depends upon whether the defense would operate in a manner consistent with SIPA and its priority system." Under SIPA, he explained, customers may assert claims for a return of principal or net equity,

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but not fictitious profits "in excess of principal that depleted the resources of the customer property fund without an offsetting satisfaction of a debt or liability of that fund."

Next, the Second Circuit rejected the Madoff Defendants' argument that the trustee could not recover the transfers because the "underlying obligation" that gave rise to them arose more than two years prior to the SIPA petition date. According to Judge Sack, when the Madoff Defendants and MIS entered into a securities contract, "no right to the transfers at issue arose." Because MIS never generated any legitimate profits from trading, he wrote, the Madoff Defendants "had no rights to the transfers let alone rights that arose prior to the two-year limitation period."

Finally, the Second Circuit was unpersuaded by the Madoff Defendants' contention that both fraudulent transfer claims and the trustee's authority to compute amounts subject to recovery are subject to two-year limitation period, and that the trustee improperly "reach[ed] back" to dates prior to the beginning of the two-year period in calculating the recoverable amount. Judge Sack stated that "[t]here is no such limitation on a trustee's 'legal authority' to compute exposure under the fraudulent transfer provisions." According to the judge, unlike section 548(a), section 548(c) does not impose a two-year limitation on assessing whether a transfer was given "for value." Judge Sack agreed with the *Greiff* district court that " '[t]he concept of harm or benefit to the estate is separate from the concept of the reach-back period . . . [and] there is no reason why a line should be drawn at the beginning of the reach-back period in determining whether a transfer was for value.' "

Outlook

Madoff is the latest installment in a decade-long saga involving hundreds of lawsuits dealing with the SIPA trustee's efforts to recover fictitious profits paid as part of the Madoff Ponzi scheme. The decision appears to foreclose definitively the defense that the recipient customers gave value in exchange for the payments in the form of discharged contract rights or "entitlements." It is possible that the Madoff Defendants will seek Supreme Court review of the ruling, but given the absence of a circuit split and the unique issues raised in *Madoff,* it appears unlikely that the Supreme Court would grant certiorari.

Madoff also reinforces the principle that, although the two statutory schemes are similar, SIPA and the Bankruptcy Code differ when it comes to prioritizing the claims of stakeholders: In keeping with its purpose, SIPA prioritizes "customers" ahead of general creditors, whereas the Bankruptcy Code does not except in certain limited circumstances (*e.g.*, certain priority consumer deposit claims).

This article should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only. The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

ENDNOTES:

[1] *In re Bernard L. Madoff Investment Securities LLC*, 976 F.3d 184, 69 Bankr. Ct. Dec. (CRR) 77, Bankr. L. Rep. (CCH) P 83572, 102 U.C.C. Rep. Serv. 2d 1422 (2d Cir. 2020).

[2] 11 U.S.C.A. § 548(c).

[3] *In re American Housing Foundation*, 544 Fed. Appx. 516 (5th Cir. 2013).

[4] *In re Bayou Group, LLC*, 439 B.R. 284 (S.D. N.Y. 2010).

[5] SIPA § 78lll(2).

[6] SIPA § 78fff-2(c)(1)(B).

[7] SIPA § 78lll(11).

[8] SIPA § 78fff-2(c)(3).

[9]SIPA § 78fff(b) (emphasis added).

[10]*See* 11 U.S.C.A. §§ 362(b)(6) and (7).

[11]*See* 11 U.S.C.A. §§ 546(e), (f) and (g).

[12]*Securities Investor Protection Corp. v. Bernard L. Madoff Inv. Securities LLC*, 476 B.R. 715 (S.D. N.Y. 2012), opinion supplemented, (May 15, 2012) and aff'd, 773 F.3d 411, 60 Bankr. Ct. Dec. (CRR) 106, 72 Collier Bankr. Cas. 2d (MB) 1295, Bankr. L. Rep. (CCH) P 82737 (2d Cir. 2014).

[13]476 B.R. at 724.

[14]476 at 725.

[15]476 at 726-27.

[16]*In re Bernard L. Madoff Inv. Securities LLC*, 773 F.3d 411, 60 Bankr. Ct. Dec. (CRR) 106, 72 Collier Bankr. Cas. 2d (MB) 1295, Bankr. L. Rep. (CCH) P 82737 (2d Cir. 2014).

[17]*California Public Employees' Retirement System v. ANZ Securities, Inc.*, 137 S. Ct. 2042, 198 L. Ed. 2d 584, Fed. Sec. L. Rep. (CCH) P 99748 (2017).

ATOMIC TRADING

By Hester Peirce

Hester Peirce is a Commissioner on the Securities and Exchange Commission. The following is adapted and edited from a speech she gave at George Washington University Law School's "Regulating the Digital Economy Conference" on February 22, 2021.

The momentous market events of several weeks ago are relevant to the theme of this year's conference—regulating the digital economy—and thus motivate my remarks. The market events to which I am referring are, of course, the Reddit-threaded run-up in the prices of a number of meme stocks, the subsequent run-down in prices, and the many attendant colorful stories. At the top of the non-financial news feed were the market volatility, trading volumes, regular Joe-to-riches stories, hedge fund losses, short squeezes, gamma squeezes, glee at sticking it to the "suits," anger at trading limitations, a jumble of emotions as stock prices fell from their highs, and debates about the intricacies of market structure.

The Securities and Exchange Commission, along with other regulators and market watchers, is still sorting through the many layers of those events, so I cannot give you a definitive assessment of what took place, let alone whether any significant regulatory changes or enforcement actions will result. Instead, I will offer some musings on the challenges that lie before the Commission as we decide whether and how to react to these events with new or modified regulations and, more generally, as we think about stepping up our game as a regulator of the digital economy.

The digital economy enabled the past month's remarkable market events—trading strategies crowd-sourced in real time on widely available social media platforms, instant retail access to the capital markets through handy mobile trading apps, institutional high frequency trading enabled by powerful computing and communications technology responding to and interacting with the retail flows, and sophisticated technology at trading venues and clearinghouses capable of handling record trading volumes. Add some primal emotions into the mix, and the regulator's job in the digital economy can be a difficult one.

Before turning to the challenges of regulating the digital economy, though, I think it is helpful to recognize that, even as our markets undergo technological transformation, our jobs in many ways will remain much as they always have been. After all, the economy, whether analog or digital, is driven by *people*; even regulators, at least until the robots replace us, are people. People, with their swirling mix of rationality and emotions are unique, interesting, and complicated. People are also fallible, frail, and often tempted to abuse power. People respond to incentives. Any effective and fair regulatory framework has to start with a recognition and understanding of people. . .People love participating in hot markets, often do so with eyes wide open to the potential for losses and fingers crossed for big gains,

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