ANALYSIS OF SECURITIES INVESTOR PROTECTION ACT COVERAGE FOR STANFORD GROUP COMPANY

INTRODUCTION

Under the Securities Investor Protection Act of 1970 ("SIPA"), the Securities and Exchange Commission is responsible for exercising plenary authority over the Securities Investor Protection Corporation ("SIPC") to ensure that SIPC properly discharges its statutory responsibilities.[1] This authority includes the power to file an application in federal district court to require SIPC to initiate a liquidation proceeding to protect customers of an insolvent broker-dealer.[2] The Commission has determined, based on the totality of the facts and circumstances of this case, that SIPC member Stanford Group Company ("SGC") has failed to meet its obligations to customers.[3] The Commission, in an exercise of its discretion, therefore is making a formal request to the SIPC Board of Directors to take the necessary steps to institute a SIPA liquidation proceeding of SGC. Should the Board refuse to take such action, the Commission has authorized its Division of Enforcement to bring an action in district court against SIPC to compel the institution of a proceeding to liquidate SGC under SIPA.

FACTUAL BACKGROUND

SGC is a broker-dealer registered under Section 15 of the Securities Exchange Act of 1934 and a member of SIPC. R. Allen Stanford ("Stanford") was the sole owner, directly or indirectly, of more than 130 related entities, including SGC, Stanford International Bank, Ltd. ("SIBL"), and Stanford Trust Company ("STC"). SIBL was a purported private international bank chartered and domiciled in St. Johns, Antigua. SGC operated through 29 offices located throughout the United States, and its principal business was the sale of securities issued by SIBL that were marketed as certificates of deposit (the "CDs" or "SIBL CDs"). As of February 16, 2009, SGC had approximately 32,000 active accounts for which it acted as an introducing broker, and those accounts were cleared and carried by Pershing LLC or J.P. Morgan Clearing Corporation. STC was a Louisiana trust

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1 *See SIPC v. Barbour*, 421 U.S. 412, 417 (1975); *In re New Times Securities Services, Inc.*, 371 F.3d 68, 77 (2d Cir. 2004).

2 SIPA Section 11(b), 15 U.S.C. 78ggg(b).

3 SIPA Section 5(a)(3), 15 U.S.C. 78eee(a)(3).

company that maintained custody of SIBL CDs in accounts of investors who purchased the CDs through IRAs.

In a civil enforcement action filed in the United States District Court for the Northern District of Texas,[4] the Commission's complaint principally alleges that for at least a decade, Stanford executed a massive Ponzi scheme centered on the sale of SIBL CDs through entities under his control, including SGC (through which U.S. investors purchased the CDs).[5] The complaint further alleges that by year-end 2008, more than $7.2 billion of SIBL CDs had been sold by falsely touting: (i) the bank's safety and security; (ii) consistent, double-digit returns on the bank's investment portfolio; and (iii) high rates of return on the CDs that greatly exceeded those offered by commercial banks in the United States.[6] The Commission has alleged that, contrary to those representations, Stanford misappropriated billions of dollars of investor money and "invested" an undetermined amount of investor funds in speculative, unprofitable private businesses controlled by Stanford.[7]

On February 19, 2009, the district court in the Commission's enforcement action appointed a receiver ("Receiver") for the assets of SIBL, SGC, Stanford, and other defendants. The Receiver has filed periodic reports that have included, among other findings, the results of its investigation of the roles played by various Stanford entities in the sale of the SIBL CDs and what happened to the funds customers invested in those CDs. The Receiver's conclusions include the following:

- The many companies controlled and directly or indirectly owned by Stanford "were operated in a highly interconnected fashion, with a core objective of selling [SIBL CDs]."[8]

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4 *SEC v. Stanford International Bank, Ltd., et al.*, Case No. 3:09-cv-0298-N.

5 Second Amended Complaint (Attachment 1), ¶ 1.

6 *Id.*, ¶ 2.

7 *Id.*, ¶ 3.

8 Report of the Receiver Dated April 23, 2009 ("Apr. 23 Report") (Attachment 2) at 5.

- The Stanford companies "did not have a typical centralized management hierarchy, nor did they have a typical governance structure for the whole network. In contrast to a conventional multi-tiered corporate structure, the stock of almost half of these entities was owned directly by Allen Stanford, rather than through a central holding company. . . . The structure was seemingly designed to obfuscate holdings and transfers of cash and assets."[9]

- "The Receiver believes . . . based on his investigation to date, that the principal purpose and focus of most of the combined operations [of the Stanford entities] was to attract and funnel outside investor funds into the Stanford companies through the sale of CDs issued by Stanford's offshore entity SIBL."[10]

- "Although all of SIBL's financial operations, including CD sales, were controlled and managed from Stanford's offices in the U.S., [SIBL] was domiciled in the Caribbean island nation of Antigua and Barbuda ('Antigua'). It appears that SIBL may have been established in Antigua in order to take advantage of Antiguan bank secrecy laws and to minimize regulatory inspection. At the same time, Stanford's financial advisors used the apparent legitimacy offered by U.S. regulation of Stanford's U.S. brokerage subsidiary in order to generate sales of SIBL CDs worldwide."[11]

In the context of its opposition to a petition pursuant to Chapter 15 of the Bankruptcy Code seeking recognition of the Antiguan liquidation as the "foreign main proceeding" for the liquidation of SIBL, the Receiver set forth the following additional facts regarding Stanford's Ponzi scheme:

- "SIB[L] was part of a massive Ponzi scheme devised and directed by Allen Stanford and his close confederates. The principal source of funding for the Ponzi scheme was the sale, worldwide, of CDs issued by SIB[L]. . . . The Stanford Ponzi scheme had two main functions: to bring

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9 *Id.* at 5-6.

10 *Id.* at 6.

11 *Id.*

in investor cash by selling fraudulent CDs and then to utilize that cash to perpetuate the scheme."[12]

- "Current sales proceeds were used to pay interest and principal on previously purchased CDs, to incentivize Stanford-affiliated financial advisors (i.e., salesmen) with above-market commissions, to richly reward Stanford's confederates for their complicity, and generally to maintain the Stanford empire's false appearance of strength. And, of course, money went to Allen Stanford himself. Lots of it. Secret SIB[L] financial records . . . list $1.8B in 'notes receivable' from Allen Stanford. Money was also bled off in other ways to support Stanford's extravagant lifestyle. Funds that were left over after all these diversions were invested, although the value of the investments totaled only a small fraction of the fictitious amount reported to the public and to regulators."[13]

- "Corporate separateness was not respected within the Stanford empire . . . . Money was transferred from entity to entity as needed, irrespective of legitimate business need. Ultimately, all of the fund transfers supported the Ponzi scheme in one way or another, or benefitted Allen Stanford personally."[14]

- "[P]rospectuses stated that the CDs were obligations of SIB[L] and not of the broker-dealer subsidiaries. In other words, the paperwork was made to look reassuringly like the documents of a real financial institution. The problem was, SIB[L] was not a real financial institution. There was no real substance to the inter-company contracts and the verbiage contained in the prospectuses, since all of the Stanford entities, SIB[L] included, were part of the same Ponzi scheme, puppets of the same puppeteer."[15]

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[12] Receiver's Response to the Antiguan Liquidators' December 3 Supplemental Brief (Dec. 17, 2009) (filed in *In re Stanford Int'l Bank Ltd.*, Case No. 3:09-cv-00721-N) ("Dec. 17 Response") (Attachment 3) at 3-4.

[13] *Id.* at 5.

[14] *Id.* at 7.

[15] *Id.* at 21.

The Receiver has also filed declarations by Karyl Van Tassel, an FTI Consulting, Inc. forensic accountant assisting the Receiver, whose analysis of available books and records of SGC and SIBL led her to the following conclusions:

- SIBL "had one principal product line—certificates of deposit—and one principal source of funds—customer deposits from CD purchases."[16]

- "Customer funds intended for the purchase of SIB[L] CDs were deposited into SIB[L] accounts and then disbursed among the many other Stanford Entities and related accounts."[17]

- "[A]nalysis of cash flows for 2008 through February 17, 2009 indicates that funds from sales of SIB[L] CDs were used to make purported interest and redemption payments on pre-existing CDs. Redemptions of principal and payments of interest on CDs should generally be paid from earnings, liquid assets or reserves. In this case, CD sale proceeds were used because sufficient assets, reserves and investments were not available to cover the liabilities for redemptions and interest payments. Although SIB[L] received some returns on investments, these amounts were miniscule in comparison to the obligations."[18]

- "It appears that most CD sale proceeds not used to pay interest, redemptions and current CD operating expenses, including commissions, bonuses, Performance Appreciation Rights Plan ('PAR') payments and up-front forgivable loans to financial advisors who sold the CDs, were either placed in speculative investments (many of them illiquid, such as private equity deals), diverted to other Stanford Entities 'on behalf of shareholder'—*i.e.*, for the benefit of Allen Stanford, or used to finance Allen Stanford's lavish lifestyle (*e.g.*, jet planes, a yacht, other pleasure craft, luxury cars, homes, travel, company credit card, *etc.*)."[19]

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[16] Declaration of Karyl Van Tassel (filed July 28, 2009) ("Van Tassel Decl.") (Attachment 4 (without exhibits)), ¶ 9.

[17] *Id.*, ¶ 10.

[18] *Id.*, ¶ 14.

[19] *Id.*, ¶ 15.

ANALYSIS

A. Basis for Instituting a SIPA Liquidation Proceeding

SIPA was enacted "to facilitate the return of the property of customers of insolvent brokerage firms or, where this cannot be done, to reimburse such customers if their property has been lost or misappropriated."[20] The House Report explained that "[t]he primary purpose of the reported bill is to provide protection for investors [by] . . . . provid[ing] for the establishment of a fund to be used to make it possible for the public customers in the event of the financial insolvency of their broker, to recover that to which they are entitled . . . ."[21]

Under Section 5(a)(3) of SIPA, SIPC may initiate a customer protection liquidation proceeding of a SIPC member where: (1) a member brokerage firm "has failed or is in danger of failing to meet its obligations to customers"; and (2) at least one of certain other specified circumstances set out in Section 5(b)(1) exists (e.g., the member is insolvent or the subject of a receivership).

Although SIPC ordinarily will not need to initiate SIPA liquidation proceedings when an introducing broker-dealer fails, courts have recognized that there are circumstances in which an investor can be *deemed* to have deposited cash with an introducing broker-dealer for the purpose of purchasing securities—and thus be a "customer" under SIPA—even if the cash is initially deposited with a different entity.[22] In so doing, courts have refused to deny investors the protections of the statute by elevating form over substance.

The Commission has determined that the statutory requirements for instituting a SIPA liquidation are met here. SGC is insolvent and the subject of a receivership. And for the reasons discussed below, the Commission has concluded that SGC has failed to meet its obligations to customers. Based on the totality of the facts and circumstances of this case, the Commission has determined (in an

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20 *SEC v. S. J. Salmon & Co., Inc.*, 375 F. Supp. 867, 871 (S.D.N.Y. 1974).

21 H.R. Rep. No. 91-1613, at 2 (1970).

22 *See In re Old Naples*, 223 F.3d 1296, 1302-04 (11th Cir. 2000); *In re Primeline Securities Corp.*, 295 F.3d 1100, 1107-08 (10th Cir. 2002).

exercise of its discretion) that SIPC should initiate a proceeding under SIPA to liquidate SGC.[23]

B. SGC has failed to meet its obligations to customers.

In concluding that investors who purchased the SIBL CDs through SGC qualify for protected "customer" status, the Commission finds two lines of cases applying SIPA particularly relevant. First, courts have held that, under certain circumstances, an investor may be deemed to have deposited cash with a broker-dealer for the purpose of purchasing securities—and thus be a "customer" under Section 16(2) of SIPA—even if the investor initially deposited those funds with an entity other than the broker-dealer. Second, courts have held that when securities purportedly acquired for customers by a broker-dealer are actually fraudulent vehicles for carrying out a Ponzi scheme, customers' "net equity" claims under SIPA can be measured by the net amount of cash customers invested and not by the purported but unreal value of the fraudulent securities (including fictitious "profits").[24]

1. The SIBL CD investors with accounts at SGC should be deemed to have deposited funds with SGC for the purchase of securities.

SIPA defines "customer" to include any person who has deposited cash with the debtor for the purpose of purchasing securities.[25] The evidence currently available shows that investors with accounts at SGC who purchased SIBL CDs deposited funds with SIBL for the purpose of purchasing securities. They clearly had the purpose of purchasing SIBL CDs, and SIPA defines "security" as including any "certificate of deposit."[26] The remaining question is whether the investors can be deemed to have deposited their cash with SGC.

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[23] Although the Commission has focused on potential customer claims of the type discussed below, it recognizes that claimants in a liquidation of SGC might present other claims that could entitle them to protection under the statute.

[24] *See In re Old Naples Securities, Inc.*, 311 B.R. 607, 615-17 (M.D. Fla. 2002); *In re C.J. Wright & Co.*, 162 B.R. 597, 610 (Bankr. M.D. Fla. 1993); *In re Bernard L. Madoff Investment Securities, LLC* ("*BLMIS*"), 424 B.R. 122, 140 n.35 (Bankr. S.D.N.Y. 2010).

[25] SIPA Section 16(2), 15 U.S.C. 78lll(2).

[26] SIPA Section 16(14), 15 U.S.C. 78lll(14).

In *In re Old Naples*,[27] the Eleventh Circuit addressed whether claimants who had deposited cash with an affiliate of a broker-dealer in order to purchase securities could nonetheless qualify as customers of the failed broker-dealer. The court held that the investors should be deemed to have deposited cash with the broker-dealer based on evidence supporting the bankruptcy court's findings that (1) the investors "had no reason to know that they were not dealing with" the broker-dealer; and (2) the funds investors deposited with the affiliate "were used by, or at least for," the broker-dealer, who "diverted some of the investors' money from [the affiliate] for personal use, and . . . used much of the money to pay [the broker-dealer's] expenses."[28] In so doing, the court focused on the substance of the transactions rather than their form.

The totality of facts and circumstances in this case supports a similar conclusion about the status of the investors with accounts at SGC who purchased SIBL CDs, i.e., that by depositing money with SIBL, investors were effectively depositing money with SGC. Based on the findings of the Receiver and his expert investigators, the separate existence of SIBL, SGC, STC, and their ultimate, sole owner, Stanford should be disregarded. [29] Credible evidence shows that Stanford structured the various entities in his financial empire, including SGC and SIBL, for the principal, if not sole, purpose of carrying out a single fraudulent Ponzi scheme. These many entities (controlled and directly or indirectly owned by Stanford) were operated in a highly interconnected fashion, with a core objective of selling fraudulent SIBL CDs.[30] The entities did not have a typical management hierarchy or governance structure, and the actual structure appears to have been designed to obfuscate holdings and transfers of cash and assets.[31] As the Receiver stated, "[t]here was no real substance to the inter-company contracts and the verbiage

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27 223 F.3d 1296 (11th Cir. 2000).

28 *Id.* at 1303.

29 *See* Dec. 17 Response at 13-15 (urging that the purported separate corporate existences of the Stanford entities —including SIBL and SGC—should be disregarded because the corporate forms were used to perpetrate the Ponzi scheme) (citing *Castleberry v. Branscum*, 721 S.W.2d 270, 271-72 (Tex. 1986); *SEC v. Resource Development International, LLC*, 487 F.3d 295, 302 (5th Cir. 2007)).

30 Apr. 23 Report at 5-6.

31 *Id.* at 5-6.

contained in the prospectuses, since all of the Stanford entities, SIB[L] included, were part of the same Ponzi scheme, puppets of the same puppeteer."[32] And courts have held that entities through which a Ponzi scheme is perpetrated are, as a matter of law, insolvent from the scheme's inception and become increasingly so as the scheme approaches its inevitable demise.[33] Consequently, all of the Stanford entities were dramatically undercapitalized—a situation that led Stanford to transfer money "from entity to entity as needed, irrespective of legitimate business need," in an ultimately futile effort to perpetuate the scheme.[34] Because the foregoing facts support disregarding the separate corporate form of the Stanford entities involved in his Ponzi scheme, they are also consistent with a finding that depositing money with SIBL was, for SGC accountholders, in reality no different than depositing it with SGC.

Additionally, as in *Old Naples*, there are facts that could have led SGC account holders who purchased SIBL CDs through SGC to believe they were depositing cash with SGC for the purpose of purchasing the CDs. Defrauded CD investors have submitted affidavits stating that they were told by their SGC financial advisors that SGC and SIBL were both members of the "Stanford Financial Group," and that Stanford financial advisers frequently referred simply to "Stanford" without clearly distinguishing between SGC and SIBL.[35] Both SGC

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[32] Dec. 17 Response at 21.

[33] *See Cunningham v. Brown*, 265 U.S. 1, 8 (1924) (Charles Ponzi "was always insolvent, and became daily more so, the more his business succeeded."); *Warfield v. Byron*, 436 F.3d 551, 558 (5th Cir. 2006); *Scholes v. Lehmann*, 56 F.3d 750, 755 (7th Cir. 1995). *See also Emerson v. Maples* (*In re Mark Benskin & Co.*), 161 B.R. 644, 650 (Bankr. W.D. Tenn. 1993) (where debtor operated primarily on fraudulently obtained funds, it would be "axiomatic that the debtor was operating its business with unreasonably small capital").

[34] Dec. 17 Response at 12; *see id.* at 19-20 ("The kind of fraud or illegal purpose that justifies disregarding the corporate veil 'is present where incoming revenues are directed away from an undercapitalized corporation and into the hands of the controlling party.'") (quoting *Bridas S.A.P.I.C. v. Government of Turkmenistan*, 447 F.3d 411, 420 (5th Cir. 2006) (internal quotation omitted)).

[35] *See*, *e.g.*, Affidavit of Sally Matthews (dated May 24, 2010) (Attachment 5) at ¶¶ 4, 5, 6 (provided along with numerous other investor affidavits to the Commission's Division of Trading and Markets as part of a submission of the Stanford Victims Coalition dated December 31, 2010).

and SIBL had the word "Stanford" in their names and used the same logo, and SGC provided at least some customers with "advisory statements" bearing that logo that listed their SIBL CD positions.[36] Purchasers also paid for the CDs in accordance with SGC's payment instructions.[37] As the Receiver found, "[m]ost CD purchasers never saw [a] SIB[L] employee, and instead dealt only with their financial advisor, who, to them, was the face of the Stanford companies, including SIB[L]."[38] One indication of investor confusion regarding the entity with which they were depositing money to purchase the SIBL CDs is that at least some customers made checks for the purchase of the CDs payable to "Stanford."[39]

There is also credible evidence that, as in *Old Naples*, the funds deposited with SIBL were diverted for Stanford's personal use and used to pay the expenses of SGC. The primary source of funding for the empire was SIBL CD proceeds. Once in Stanford's control, he used those funds indiscriminately to support the various Stanford entities and his lavish lifestyle.[40] In particular, he used those funds for the benefit of SGC, by making capital contributions, paying SGC's operational expenses, and paying concessions and bonuses to SGC representatives for selling the CDs. Indeed, SGC could not have remained operational without the inflow from CD proceeds.[41]

Based on the totality of the facts and circumstances, the Commission has concluded that investors with brokerage accounts at SGC who purchased SIBL CDs through SGC should be deemed to have deposited cash *with SGC* for purposes of SIPA coverage. Doing otherwise on the facts of this case would elevate form

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36 *See* Matthews Affidavit at ¶ 6; Letter to Chairman Schapiro from Matthew B. Comstock, counsel for the Stanford Victims Coalition, dated Nov. 12, 2009 ("Comstock Nov. 12 Letter") (Attachment 6), at 9-10.

37 Comstock Nov. 12 Letter at 10.

38 Dec. 17 Response at 11; *see also* Matthews Affidavit at ¶ 5 ("My only point of contact with any [of] the Stanford Financial Group of Companies was [SGC financial advisor] Doug Shaw. I never spoke to anyone at [SIBL].").

39 *See* Attachment 7.

40 *See* Dec. 17 Response at 12; Van Tassel Decl., ¶ 15.

41 *See* Apr. 23 Report at 6-7.

over substance by honoring a corporate structure designed by Stanford in order to perpetrate an egregious fraud.

In an August 14, 2009 letter to the Receiver, SIPC President Stephen P. Harbeck stated that "if SGC and SIBL are consolidated . . . the CDs are, in effect, debts of SGC, and are part of the capital of SGC. Such a relationship negates 'customer' status under 15 U.S.C. § 78lll(2)(B) [as amended, § 78lll(2)(C)(ii)]."[42] The Commission disagrees for the reasons the courts in *C.J. Wright*, *Old Naples*, and *Primeline* rejected similar arguments advanced by the SIPA Trustee as grounds for denying customer status. In *C.J. Wright*, the court found that claimants "believed they were depositing funds for the purchase of securities and were not told and were not aware that their investment was to become part of debtor's capital."[43] "Because claimants did not intend to loan money to debtor and were unaware that this may have been debtor's intention," the court rejected "the Trustee's determination that the deposit account transactions were loans" that negated customer status.[44] Applying the same reasoning, the Eleventh Circuit in *Old Naples* rejected the Trustee's argument that, even if the claimants could be deemed to have deposited money with the broker-dealer, they were not "customers" because they were effectively lending money to the broker-dealer: "There is ample evidence that the claimants believed Zimmerman would buy the bonds in their names and for their individual accounts. It is true that a fixed rate of return is often associated with loans, but the bankruptcy court noted that it is often characteristic of bonds as well."[45] In *Primeline*, the Tenth Circuit likewise focused on the intent of the claimants in rejecting the argument of the Trustee and SIPC that the claimants were excluded from the definition of "customer" because they were "lenders" of the broker-dealer who had claims to the capital of the debtor: "The bankruptcy court found Claimants intended to invest, not loan, the funds each entrusted to [the broker-dealer's registered representative]. This finding is fully supported by the record."[46] Here, too, deeming investors with accounts at SGC to have deposited cash with SGC for the purpose of purchasing the SIBL CDs does

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[42] *See* Attachment 8.

[43] 162 B.R. at 606.

[44] *Id.*

[45] 223 F.3d at 1304 (citations omitted).

[46] 295 F.3d at 1109.

not convert those CD investments into debts of SGC that are excluded from SIPA's protections. There is no evidence that the SIBL CD purchasers *intended* to loan money to (or otherwise invest in) SGC, and the purchasers had no reason to know that, in fact, their money was being funneled into a common fund that Stanford used to keep SGC (and the Ponzi scheme of which it was an integral part) afloat.

2. <u>Customers' claims should be based on their net investment in the fraudulent CDs that were used to carry out the Ponzi scheme.</u>

In a SIPA liquidation, customers are entitled to payments based on their "net equity." As relevant here, SIPA defines a customer's net equity as "the sum which would have been owed by the debtor to such customer if the debtor had liquidated . . . on the filing date . . . all securities positions of such customer."[47] Typically, where a customer authorizes a broker-dealer to purchase securities and the broker-dealer confirms the purchase, a customer's net equity in a SIPA liquidation of the broker-dealer is limited to the securities or their market value on the date the liquidation proceeding was filed. But in SIPA cases involving Ponzi schemes perpetrated by inducing customers to acquire fraudulent securities or securities positions, courts have concluded that a defrauded customer's net equity should be based on the net amount the customer invested and *not* the value of the securities positions shown on the customer's account statement.[48] The rationale for disregarding the fraudulent securities positions in those cases is that, in a Ponzi scheme, the fund of customer property that would be used to satisfy net equity claims consists only of the money invested by defrauded investors that has not been distributed as redemptions and fictitious "profits" or otherwise misappropriated by the fraudster. As such, valuing customers' net equity based on the purported securities positions and profits used to perpetrate the scheme—rather than customers' net investment in the fraudulent scheme—would give effect to the fraudulent scheme and lead to inequitable results not consistent with SIPA's purpose:

> [P]ermitting claimants to recover not only their initial capital investment but also the phony "interest" payments they received and rolled into another transaction is illogical. No one disputes that the interest payments were not in fact interest at all, but were merely portions of other victims' capital

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[47] SIPA Section 16(11), 15 U.S.C. 78lll(11).

[48] *Old Naples*, 311 B.R. at 615-17; *C.J. Wright*, 162 B.R. at 610; *BLMIS*, 424 B.R. at 140 n.35.

> investments. If the Court were to agree with the Athens claimants, the fund would likely end up paying out more money than was invested in Zimmerman's Ponzi scheme. This result is not consistent with the goals of SIPA, which does not purport to make all victimized investors whole but only to partially ameliorate the losses of certain classes of investors.[49]

In its net equity decision in the Bernard L. Madoff Investment Services liquidation under SIPA, the bankruptcy court agreed with (and quoted) the foregoing reasoning in support of its decision that the net equity of customers who were victims of Madoff's Ponzi scheme should be based on their net investment with Madoff and not the securities positions reflected in their account statements.[50] Counsel for the SIPC Trustee made the same point during the recent oral argument in the Second Circuit in defending the decision to calculate customers' net equity based on the money they invested rather than the securities positions Madoff confirmed he had purchased for them: "This is a Ponzi scheme. It's a zero-sum game. The customer fund is the money that went in. We can't talk about anything else. Can't talk about profits. Can't talk about stocks."[51]

The Commission has concluded that the facts of this case support a similar approach to calculating the SIBL CD customers' net equity. Credible evidence shows that SGC, among other Stanford entities, was used to carry out a massive, long-running Ponzi scheme.[52] SGC's sole owner, Stanford, ultimately controlled all investor funds and used them to make redemption and purported interest payments to earlier investors, to support the entities that were perpetrating the scheme, and to fund his own lavish lifestyle.[53] The Receiver's forensic accountant concluded that the returns on investments that Stanford made with the proceeds of CD sales were "miniscule" in comparison with SIBL's liabilities for redemptions and interest payments related to those CDs.[54] SIBL's assets were, in effect, a mere

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[49] *Old Naples*, 311 B.R. at 617.

[50] *BLMIS*, 424 B.R. at 140 n.35.

[51] Excerpt of Transcript of Oral Argument at 51, *In re Bernard L. Madoff Investment Securities, LLC*, No. 10-2378 (2d Cir. Mar. 3, 2011) (Attachment 8).

[52] April 23 Report at 5-6; December 17 Response at 8-12, 26.

[53] December 17 Response at 10.

[54] Van Tassel Decl., ¶ 14; *see also id.*, ¶ 27 ("The SIB[L] CDs were SIB[L]'s only product line. Although SIB[L] provided a limited number of other financial

collection of the money Stanford obtained from investors through his Ponzi scheme. As the Receiver's investigators have found, it was ultimately impossible for Stanford to make the promised redemption and interest payments without using other investors' funds, and if all of the investor funds (and assets acquired with those funds) had been swept away, there would have been virtually nothing left.[55] In the Commission's view, the same logic that has led courts to disregard fictitious interest and profits for purposes of calculating net equity also supports disregarding the issuance of instruments—like the SIBL CDs—that in actuality are nothing more than participatory interests in a Ponzi scheme. Thus, as in the C.J. Wright, Old Naples and Madoff Ponzi schemes, the customers' net equity should be calculated based on their net investment in the SIBL CDs and not based on the value of the fraudulent CDs that Stanford used to carry out his scheme.

<u>Conclusion</u>

For the reasons set forth above, the Commission has concluded that SIPC should initiate a SIPA liquidation of SGC. In choosing to exercise its discretion in this instance, the Commission has considered relevant facts and circumstances, including the potential costs and benefits of initiating a SIPA liquidation proceeding in this case. In a further exercise of its discretion, the Commission has authorized its staff to file in district court an application under Section 11(b) of SIPA to compel SIPC to initiate a liquidation proceeding in the event SIPC refuses to do so.

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products (*e.g.*, credit card services and loans), these were offered only to CD holders and acted as incentives for the purchase of CDs.").

[55] *Id.*, ¶ 24 ("The substantial majority of funds used to pay purported CD interest and redemption payments to investors on pre-existing CDs was proceeds from sales of new SIB[L] CDs[.]").