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**Feeder Funds and the SIPC
National Affairs
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I'm probably missing something, in fact I'm probably missing a lot, but as far as I know there has been little in the way of official release of certain crucial numbers related to the Madoff scam. The government has said that \$65 billion was lost; I presume that \$65 billion is the collective total shown on the November 30, 2008 statements, and it therefore is the number I shall use here for the total loss. It has been estimated at various times, if memory serves, that there were either 8,000 accounts or 13,000 accounts. But these would seem to be the number of accounts listed with Madoff, and, since a feeder fund was but one account, these numbers do not include any of the persons who invested through the feeder funds. It has also been estimated - with what accuracy I have no idea - that if you were to count all the people who invested through feeder funds, pension funds, etc., there are 50,000 people who lost money with Madoff.

The numbers - which we generally cannot know for sure at present because of silence by those who may know them - are especially important with regard to restitution from SIPC (as well as certain other modes of restitution). For the numbers can tell us what the chances of recovery from SIPC actually are.

In this connection, though I personally am a direct investor, I am one of those who have never understood the morality or the decency of denying SIPC recovery to those who invested through feeder funds. In this regard, I once pointed out on a MadoffSurvivors Steering Committee phone call (or Advisory Committee phone call or a whatever-it-is-now-called phone call) that the SIPA's use of the word "customer," the word which is the basis of excluding feeder fund investors from obtaining SIPC

recoveries, does not itself exclude investors through feeder funds from being customers. There is nothing ex cathedra or from on high about it. Rather, the definition of customer that causes feeder fund investors to be excluded from individual recoveries is judge made law, law made decades ago by courts in accordance with arguments put forth by SIPA. This point was met on the phone call with a degree of hostility and scorn on the part of one individual that was startling if not shocking. (As I understand it, the individual claimed - wrongly - that the definition of customer which excluded feeder fund investors was from the statute rather than from judicial rulings.) It was in part this person's continuing vitriol (not to mention other, related conduct that the Advisory Committee knows of very well) that caused me to resign from the Advisory (or Steering) Committee about two weeks ago. But the fact nonetheless is that the definition of "customer" which excludes feeder fund investors is not in the SIPA statute, but goes back, as near as I can tell, to the 2d Circuit court of appeals opinion in early 1976 in *SIPC v. Morgan, Kennedy & Co.* This was before there were feeder funds, as far as I know, although at the time there were smaller collective groups of defacto or de jure investors such as the 108 person profit-sharing plan involved in the Morgan, Kennedy case itself. Of course, even though the Morgan, Kennedy interpretation of customer is not suitable to current conditions, its age - 33 years - may make it "undislodgeable" so to speak.

Recently, however, to judge by the traffic on *MadoffSurvivors*, some investors through feeder funds, who claim - perhaps rightly (probably rightly?) - to be the large majority of people who lost money, are beginning to rebel against the focus (as I and others see it) mainly on direct investors, with associated lack of focus on feeder fund investors. There are feeder fund investors who seem no longer to accept the argument that the group must focus on what its leaders regard as more doable - e.g., getting rid of Picard's unjustifiable definition of net equity, and raising the SIPC recovery to \$1.6 million, all for direct investors, instead of trying to get SIPC recovery for indirect investors who invested through feeder funds.

Now, it may be that certain numbers will make it insuperably difficult to have the definition of "customer" changed to include investors through feeder funds. (I shall discuss these numbers below.) But if this is true, it should reinforce in people's minds, especially people who were feeder fund investors, the vast importance of seeking other forms of restitution, especially restitution through taxes. The IRS' recently announced "safe harbor" provisions for theft deduction exclude feeder fund investors because they are not so-called "qualified investors." This is an outrage. As adequate as the IRS' recent revenue ruling and procedure may be for some people (especially the very wealthy who will obtain deductions worth scores of millions or more), it is vastly inadequate for others, and people should work on getting them changed to include feeder fund investors. People should also get behind the efforts of Steve Breitstone to obtain a change in the tax law that would allow persons to get refunds of taxes paid on phantom income going back to 1995 or 1992 (when the SEC assured people - wrongly - that the deal was on the up and up, that there was no fraud, no Ponzi scheme). A combination of making theft deductions available to feeder fund investors who paid taxes, plus tax refunds for all defrauded investors going back to 1995 or 1992, would go far towards providing adequate though not full restitution for many who for years paid the IRS taxes to which it had no right and which resulted from a scam that the IRS itself seems to have furthered in 2004 by approving of Madoff as a non-bank custodian for IRAs in violation of the IRS' own regulations.

Of course, though people should focus on getting legislative corrections of the IRS' inadequate recent tax guidance and on obtaining legislation allowing refunds, this won't help those who did not pay taxes: charities, IRAs, pension plans, etc. To help them, something else is needed: either recovery through SIPC, which would leave many of them vastly short of adequate restitution for the governmental derelictions committed by the SEC and, apparently, the IRS too, or recovery through a plan that I think better than anything currently in focus. The plan in mind would cover all investors of any type, would enable them to obtain roughly the same annual income as before though they would have to wait several years to recover principal, and would cost the government less money for many years than anything else that people currently have in mind.

Speaking candidly, I am going to pursue this plan pretty much by myself for a few weeks, in order to see whether it initially gets a good or bad reception. If it gets screwed up at the beginning, I want to be the one who screws it up, rather than having it screwed up by people with whom I am in disagreement, to put it gently. Regardless of whether it initially meets with a good reception or a poor reception, I will eventually let people know about it, so that they can help if they wish. But at the beginning I shall pursue it alone, while urging readers to get behind Steve Breitstone's efforts to obtain tax refunds, which would be enormously helpful, at least to those who have paid taxes on Madoff income for a considerable number of years.

Now let me turn to numbers which may drive what can be accomplished with regard to obtaining recovery for feeder fund investors through SIPC. This problem of assessing the numbers is made more difficult because only Picard, SIPC, the IRS, perhaps the U.S. Attorney's office and / or other governmental or quasi governmental bodies can currently know or even reasonably estimate actual numbers involved. And, if they do know the relevant numbers, they generally are not talking.

But let's assume that whoever has opined that there are 50,000 victims if one includes feeder funds is right. Let's further assume that, if feeder fund investors were eligible for SIPC recoveries, only half of the 50,000, or 25,000, could recover \$500,000 from SIPC under Picard's crabbed definition of net equity. Twenty-five thousand times \$500,000 is \$12,500,000,000 (twelve billion, five hundred million dollars). If SIPC recovery were raised to \$1.5 million (people generally use the figure \$1.6 million, but I am using \$1.5 million to keep the multiplication really simple), the amount of SIPC recovery would be \$37.5 billion dollars.

If approximately two-thirds of the 50 thousand people - for simplicity let's call it 35,000 of them, which is just over two-thirds - are eligible for a full SIPC recovery of \$500,000, then the amount of recovery would be \$17,500,000,000 (seventeen billion, five hundred million dollars). If the recovery was raised to \$1.5 million, the total would be \$52,500,000,000, (52 billion, 500 million dollars, or just over 80 percent of the total government-claimed loss of \$65 billion).

Now assume that only one quarter of the assumed 50,000 people, or 12,500 people, are eligible for a full SIPC recovery. At a recovery of \$500,000 per person, the SIPC restitution would be \$6,250,000,000 (six billion, two hundred and fifty million dollars), and at a recovery of \$1.5 million per account, the restitution would be \$18,750,000 (eighteen billion, seven hundred and fifty million dollars).

Now, these figures are all very rough, very approximate. The number of people involved is totally an assumption. The number eligible for full recovery is totally an assumption. That some of these or others would be eligible for only partial recovery is ignored. But even though all the figures are mere assumptions, I think the figures nonetheless give you a sense of the orders of magnitude that are involved if feeder fund investors were eligible for SIPC recoveries (orders of magnitude which, as far as I know, nobody has tried to assess before, at least not publicly). The orders of magnitude lend numerical backing to people's instinctive thought that Picard and Harbeck are trying to restrict and lowball investors to the maximum extent possible. One wonders what Picard and Harbeck think will be the total SIPC payout - what they plan for the total SIPC payout to be. If I had to make a sheer guess, albeit one based on Harbeckian statements regarding SIPC's ability to meet the demands upon it, I would speculate that they intend to hold SIPC's total outlay - its payments to investors minus amounts received from clawbacks - to somewhere in the neighborhood of one and one-half to two billion dollars. If one calls it two billion - which may be generous - and one assumes the number of direct investors is a number about half way between various estimates - let's say the number is 10,000 direct investors - - this comes out to \$200,000 per investor on average. (\$200,000 times 10,000 investors is two billion dollars.) To confine SIPC payments to an average of \$200,000 per investor, Picard and Harbeck have to be very stingy, they have to use the illegal cash in/cash out method so as not to pay anything to people who lived on Madoff earnings, they have to refuse to consider providing restitution for people in feeder funds, they have to claw back (at least from those who are not plainly innocent), and they have to fight raising the top limit of recovery from \$500,000 to \$1.6 million.

Indeed, you can rest assured in my judgment that Picard and Harbeck will fight to the last ditch in court against any effort to change any of what they are doing, e.g., any effort to force upon them a different definition of net equity than their illegal cash in / cash out basis, and any effort to change the judicially-created definition of customer so that it would include feeder fund investors instead of excluding them.

With regard to the fight Picard and Harbeck will put up in court, I understand that some of the expert SIPC and SEC lawyers who were found by the Steering Committee are expressing concern that Picard is now turning down investors whose lawyers (if any?) will not be versed in the law of SIPC, of bankruptcy, of securities regulation. The fear is that the first appeals will therefore be taken, and the governing precedents will be set, in cases which match highly experienced, very knowledgeable lawyers for SIPC and Picard against lawyers who are basically ignorant of the relevant fields of law. This is a serious matter. It is not to be treated lightly.

Some time ago I suggested that, in order to avoid "turndowns" by Picard based on improper principles (like his definition of net equity), the lawyers found by the Steering Committee should bring what is called a declaratory judgment action seeking a judicial ruling that Picard could not do what he had plainly said he is going to do and what it seems he may now have begun doing. The suggestion was rejected on grounds I found at least reasonable even though I disagreed with them. But now it seems ultra clear that, no matter what, the knowledgeable lawyers had better start preparing what are called "friend of the court," or "amicus curiae," briefs that will be filed in any case of a "turndown" that is appealed to any court - bankruptcy district, appellate or what not.

As well, the lawyers should prepare motions to intervene in any such appeal. (I have filed both kinds of documents in my career, including amicus briefs by the dozens in the Supreme Court and papers seeking intervention in a gigantic governmental antitrust case in a federal district court). Whether done as an amicus paper, as a motion to intervene, or as both in the alternative, the paper should discuss the state of the relevant law generally, should discuss the New Times case in particular, and should elaborate the evidence, the actual evidence regarding the lawyers' own clients and others, that the lawyers wish to present to the court for its consideration because the evidence bears on relevant matters.

To now go back to a main thread, however, it seems obvious that, because of the order of magnitude of the numbers that likely are involved, it will be impossible to get Picard or Harbeck to voluntarily change the definition of "customer" they follow so that it would include feeder fund investors instead of excluding them, or to voluntarily change the definition of net equity that they are using. On appeal, at least if the appeal is manned (or womanned) by good lawyers on the investors' side, there is an excellent chance that Picard and Harbeck will lose on their definition of net equity. As lengthily discussed here before, their definition, in my judgment, flies in the face of the recent 2004 court of appeals decision in New Times; and Picard and Harbeck therefore could easily lose even though such a loss will cost SIPC a fair amount of money.

But it will be harder to defeat Picard and SIPC in court on the definition of customer, which presently excludes feeder fund investors, because this definition, even though it was established before there were feeder funds and is wholly inadequate for today's world, nonetheless was established thirty-three years ago. Plus, Harbeck and Picard will play on courts' always-present fear of costing governmental or quasi governmental bodies a lot of money. A new definition of customer that includes feeder fund investors would upset a case-law definition followed for 33 years (as opposed to following the New Times decision that is only five years old), could cost SIPC tens or even scores of billions of dollars, and therefore is not a definition a court may wish to embrace. Morality and decency probably won't enter into it in court when it comes to departing from a long settled rule, even one that is out of sync with modernity. The courts are likely to say investors should go to Congress for relief on this particular point.

So... to conclude: Much as I personally favor including feeder fund investors in SIPC recoveries, this is going to be a hard row because of the amounts of money this would cost SIPC. I suspect feeder fund investors may be better off putting extensive efforts into backing Steve Breitstone's efforts regarding income tax refunds, seeking a legislative or regulatory change that makes them eligible for theft deductions under the (concededly inadequate) safe harbor procedure, seeking other changes from Congress (including increases in the amount recoverable from and the persons who can recover from SIPC), and backing a plan that I will be working on alone for awhile but will present publicly after initial contacts regarding it, whether those contacts prove promising or unpromising.


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