

## Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—2nd Cir: Madoff Investors Not "Customers" Under SIPA, (Feb. 22, 2013)

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By Lene Powell, J.D.

A three-judge panel of the Second Circuit Court of Appeals affirmed a NY district court ruling that injured investors did not qualify as "customers" of Bernard Madoff's failed fund under the Securities Investor Protection Act (SIPA). (*In re: Bernard L. Madoff Investment Securities*, February 22, 2013, Leval, Raggi, and Livingston).

The appellant investors sought to be recognized as customers of Bernard L. Madoff Investment Securities (BLMIS) in order to obtain coverage under SIPA, which would potentially provide compensation for uncompensated losses up to a cap of \$500,000 per customer. Appellants did not invest directly with BLMIS, however. Rather, they invested with two limited partnerships, which in turn invested in two hedge funds, Rye Select Broad Market Fund and Rye Select Broad Market Prime Fund. The hedge funds, or "feeder funds," advised investors and invested the pooled capital with BLMIS through securities accounts maintained only in the funds' names. Thus, the question was whether the investors or the feeder funds were the "customers" of BLMIS.

The appellate panel reviewed the bankruptcy court's conclusion independently and found no error in its ruling that the individual investors did not qualify as "customers" under SIPA. The panel noted that circuit precedent supported a narrow interpretation of "customer," which is defined to include persons who have "deposited cash with the debtor for the purpose of purchasing securities" and who have a claim arising out of "sales or conversion" of those securities.

The panel identified the "critical aspect" of the customer definition to be the entrustment of cash or securities to the broker-dealer for the purposes of trading securities. Appellants did not meet this requirement because they had no direct financial relationship or securities accounts with BLMIS, they had no property interest in and lacked control of the assets the feeder funds invested with BLMIS, and they were not identified in BLMIS's books and records. The court stated that regardless of their intent, appellants "never entrusted their cash or securities" to BLMIS, and thus failed to satisfy a critical aspect of the "customer" definition.

The panel affirmed the SDNY district court decision, which was entered on June 6, 2012 affirming the bankruptcy court's order of June 28, 2011, which in turn affirmed Trustee Irving H. Picard's decision.

Attorneys: Jennifer A. Clark and Brian J. LaClair (Blitman & King, LLP) for Bricklayers and Allied Craftsmen Local 2 Annuity Fund, Central New York Laborers Pension Fund, Laborers' Local 103 Annuity Fund and et. al. William L. Chapman (Orr & Reno, P.A.) for James L. Kruse, Henry T. DeNero, Nancy S. DeNero and Charles F. Rolecek. Mark I. Silberblatt (Bisceglie & DeMarco, LLC) for Upstate New York Bakery Drivers and Industry Pension Fund. Helen Davis Chaitman (Becker & Poliakoff, LLP) for Neva Rosamilia and Nicholas Rosamilia. Josephine Wang, Lauren T. Attard, Kevin H. Bell and Christopher H. LaRosa (Securities Investor Protection Corporation) for Securities Investor Protection Corporation. David J. Sheehan, Seanna R. Brown, Wendy J. Gibson, Jorian L. Rose and Thomas D. Warren (Baker & Hostetler, LLP) for Irving H. Picard.

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