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Highlights

Highlights of GAO-12-991, a report to congressional requesters

September 2012

SECURITIES INVESTOR PROTECTION CORPORATION

Customer Outcomes in the Madoff Liquidation Proceeding

Why GAO Did This Study

After the collapse of Bernard L. Madoff Investment Securities, LLC—a broker-dealer and investment advisory firm with thousands of individual and institutional clients—the Securities Investor Protection Corporation (SIPC), which oversees a fund providing up to $500,000 of protection to qualifying individual customers of failed securities firms, selected a trustee to liquidate the Madoff firm and recover assets for its customers. In March 2012, GAO issued GAO-12-414, which examined selection of the Trustee, his method for determining customer claims, and expenses of the liquidation, among other things. This report discusses (1) the extent to which account activity varied by type of Madoff customer, (2) the nature of claims filed, and rejected or approved, with the Trustee for reimbursement of losses, (3) litigation and settlement activity the Trustee has pursued in seeking to recover assets for distribution to customers, and (4) the effect of the fraud on customers' federal income tax liabilities. GAO reviewed transaction and claims data from the Trustee, lawsuits filed by the Trustee, IRS rules and guidance, and interviewed the Trustee, private sector tax experts, and officials from IRS, SIPC, and the Securities and Exchange Commission.

View GAO-12-991. For more information, contact A. Nicole Clowers at (202) 512-8678 or clowersa@gao.gov

What GAO Found

GAO's analysis of Madoff account data shows that more than three-fourths of the firm's customers were individuals and families (individuals). The remaining accounts were held by institutions, such as pension funds and charities. A higher proportion of accounts held by an individual (60 percent) were "net winners" based on their net equity position—meaning they had withdrawn more from their accounts than they had deposited—compared to accounts held by institutions (50 percent). Correspondingly, 40 percent of institutional accounts were "net losers" that had deposited more into their accounts than they had withdrawn, compared to 29 percent of individuals' accounts that were net losers. However, individual and institutional accounts had similar deposit and withdrawal activity from 1981 through 2008, including increased withdrawals immediately before the firm's failure in December 2008.

GAO's analysis shows that the Trustee's decisions to accept or reject claims were similar for individual and institutional account holders. Of the more than 16,000 claims, about 66 percent were denied because the customers were not direct account holders of the Madoff firm, but instead had invested in funds or other vehicles that held accounts directly with the firm. For the remaining claimants who were directly invested, the Trustee generally used the customers' net investment positions—that is, whether they were net winners or net losers—to determine claims. In examining claims decisions by customer type, GAO found the Trustee denied claims filed by individuals and institutions determined to be net winners in similar proportions. Similarly, most claims filed by individuals or institutions determined to be net losers were allowed.

The Trustee has been pursuing litigation to recover, or "claw back," assets from net winner customers and others that can be used to reimburse customers that did not withdraw all of their principal investments. For those customers that withdrew fictitious profits—net winners—the Trustee has been pursuing more than 1,000 lawsuits to recover funds, as allowed under federal bankruptcy law and state law. In about 60 suits, the Trustee has sought more than fictitious profits, to include principal or other funds received, arguing the parties knew or should have known of the fraud. Thus far, the Trustee said he has recovered about $9.1 billion of the $17.3 billion in principal investments lost by customers who filed claims, including $8.4 billion from settlement agreements.

Because the Madoff fraud affects customers' taxable income, it also affects tax collections by the Department of the Treasury. Under Internal Revenue Service (IRS) rules, Madoff customers can deduct lost principal and fictitious profits on which they paid taxes while holding their accounts. However, IRS does not maintain statistics on specific frauds or their impacts on tax collections, and the tax impact may be reduced because some taxpayers may not be able to fully use this tax relief, such as those that lack other income that can be offset by these deductions. Tax experts expressed concerns about the lack of clarity over how payments stemming from fraud-related avoidance actions filed by the Trustee will be treated for tax purposes. In response to a recommendation in a draft report that IRS provide guidance to help limit taxpayer errors resulting in over- or underpayment of taxes, the agency issued such guidance on September 5, 2012, in the form of "frequently asked questions" posted to its website.