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Ponzi of All Ponzis: Critical Analysis of the Bernie Madoff Scheme

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Abstract Bernie Madoff perpetrated the largest Ponzi scheme in American history, by utilizing a fraud methodology that dates back to the mid 1800s. Madoff was able to steal roughly $65 billion dollars, during the course of multiple decades. Due to the elaborate nature of the fraud and the reputable public perception of Madoff, the scheme not only went uncovered after multiple Securities and Exchange Commission (SEC) tips and pre-investigations, but also continued to grow and increase in popularity, among investors worldwide. The SEC conducted haphazard investigations and utilized inexperienced examiners that lacked support and guidance from senior leaders. The SEC also had understaffed personnel, which kept over-worked investigators from thoroughly examining Madoff's network. In this research paper, the author provides a critical analysis of the entire incident and also broadens the discussion to capture lessons learned, while extrapolating the details to consider fraud prevention techniques that can be used by organizations of all sizes, in multiple industries. The author offers recommendations to investors to reduce the potential of falling victim to future Ponzi schemes and/or other fraudulent behavior in corporate settings. The research includes recommendations for investigators so they are prepared to quickly discover and eliminate Ponzi schemes and other fraudulent activities, while mitigating losses. Lastly, insight into the reform and modifications that have occurred within the SEC as a result of the Madoff Ponzi scheme will be reviewed.

Keywords*: ponzi scheme, financial risk mitigation strategies, forensic accounting*

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1. Introduction

The environment is small, dark, depressing, and cold. There is isolation, confinement, no more flashing lights, screaming reporters, angry victims, and Federal US Marshall escorts to and from court. However, despite the seclusion and absence of angry spectators; there still is little-to-no peace for Bernie Madoff inside his Federal Prison cell. There is now only embarrassment and his fatally ill kidney disease that is on the verge of taking his life [3]. The irony of it all is, despite Madoff's unprecedented crime and the billions of dollars that he stole from victims, he receives top of the line, state of the art, free medical care, while many working Americans find themselves at-risk of having their healthcare under the Affordable Healthcare Act stripped away in the coming years, due to policy changes. Perhaps the unfair and flawed systemic backdrop provided by Madoff's excellent healthcare that is funded by taxpayers, is a metaphor for the scheme that also robbed taxpayers and was not discovered by federal authorities for several decades.

Madoff was convicted of operating a $65 billion Ponzi scheme in 2009 and sentenced to 150 years in prison (New York Times, 2009). He is currently serving out his life sentence in a state-of-the art, LEED certified penitentiary outside Durham, NC. However, Madoff has not been able to enjoy his new, sustainably constructed home in peace. Shortly after arriving at the institution, Madoff was placed in solitary confinement within the institution's medical wing, due to safety concerns from other inmates [13]. This was also in part to his deadly, stage four kidney disease [3]. Madoff has since returned to general population, but remains a frequent visitor and recipient of free healthcare at the medical wing and local hospitals.

The Bernie Madoff Ponzi scheme was unprecedented in nature and stature. Ponzi schemes are not new, they have been around since the mid 1800's and were made popular in the early 1900's, by mastermind fraudster Charles Ponzi, who cost investors roughly $20 million in 1920 [11]. However, Ponzi's fraudulent act pales in comparison to Madoff's, even when inflation is factored in.

The way that Ponzi schemes work is the fraudster offers excessively high returns to potential investors, in a very short time period. They usually request larger and major investments, due to the promise or potential for excessively high returns [19]. They also cover their tracks by reiterating the risk associated with the investments. This is often why you may find Ponzi schemes being conducted within speculative investment arenas, such as Hedge Funds.

Most (oftentimes none) of the dollars received from investors are not actually put into any reputable investment portfolios. Instead a portion of the investment funds are taken from new investors and passed on to the

older clients, while being disguised as "returns" [19]. The remaining funds received from new investors are then utilized by the fraudster for their own personal gain. To long-term clients, it appears that they are receiving a consistent, steady, and reliable return on their investment…so they are more likely to be satisfied and remain engaged with the investment opportunity. These current clients often will even reinvest their own funds back into the investment opportunity (scheme) due to their excitement and joy of receiving such high returns on a consistent basis. These same clients also tend to become the biggest spokespersons and recruiters for the Ponzi schemes, unknowingly recruiting friends, family, colleagues, and associates into these frauds under the impression that it is a stellar investment opportunity.

The entire initiative is very risky and oftentimes will eventually fall apart. This is primarily because Ponzi schemers must continuously have an on-going base of new clientele, investors, and interested parties who are putting funds into the investment portfolio. If they (fraudsters) are unable to continuously obtain new investors, with new funds, then the entire scheme will unravel, as the fraudsters will not have the availability in funds to continue repaying current investors their returns [19]. This is usually when the Ponzi schemers pack up and run, leaving their investors with no opportunity to retrieve their invested funds. However, never in history has a Ponzi scheme grown to the magnitude, nor carried on for the length of time that Madoff's illegal network did [19]. Some suspect that the scheme dated back to the Mid-to-late 1970's, and ultimately costs investors roughly $65 billion.

Ultimately, despite the red flags, excessively high returns on investments that Madoff received for several years, requests and attempts to investigate Madoff and his firm, the Securities and Exchange Commission (SEC) never uncovered the scheme [7]. During the economic downturn of 2008, excessive amounts of requests flowed in to Madoff from investors to withdraw their funds. Madoff was unable to meet the demands of his clients and eventually confessed to his sons what truly was going on. His sons later alerted authorities and then a formal investigation was opened, which led to Madoff being charged (Hilzenrath). It is hard to believe a fraudulent scheme of this magnitude could go on for so many years and negate several red flags, investigative requests, and even some of the initial investigative attempts…but it did.

So how did a scheme of this magnitude go unnoticed by regulatory officials? How did Madoff not only fool inexperienced, unsuspecting investors, but more savvy and experienced ones as well? What can be done to keep a scheme of this magnitude from happening again in the future? These are questions that will be investigated in more detail, by conducting a thorough review of the literature and analyzing the Bernie Madoff case. At the conclusion of this research, the author will offer recommendations to corporate leaders, investors, and regulatory agencies to prevent a scheme of this magnitude from happening in the future.

1.1. Introduction to Ponzi Schemes

Greed has plagued society for many years. Whether it is blood thirsty nations and dictators seeking to dominate the world, bank robbers going back for "one more grab," or fraudulent religious leaders acting as wolves and preying on their "flock" while posing as shepherds. Greed also contributes to much of the fraud that is perpetuated as well [9] Normally greed is attributed to the fraudsters alone, but what about the victims?

Oftentimes the victims overlook vital red flags, warning signs, and more practical thinking in hopes of receiving large financial returns that just seem to be too good to be true. This is especially the case for Ponzi scheme investors. The researcher proposes greed as a major component to Ponzi schemes, because investors in these networks are typically promised large, quick, financial returns on investments [14,17]. Ponzi scheme operators will not only promise, but they also provide what seems to be good returns when the schemes are operating well. However, unbeknown to investors, they are not receiving returns from any investments, but instead are collecting money that was invested by other victims of the Ponzi scheme.

It is not unusual to find that Ponzi scheme fraudsters are typically aggressively pursuing new investors. This is because Ponzi schemes are based upon continual recruitment of new investors [14,17]. New investors are required in order to keep previous investors satisfied with "returns." Even though Ponzi schemes can last for extended periods of time without any major problems, there are a few major factors that can quickly lead to the schemes collapsing.

As was mentioned previously, Ponzi schemes require a steady flow of new investors, which contributes to new funds and returns that can be distributed amongst investors. So it is no wonder that the lack of new investors and inflowing funds is one of the major contributing factors to Ponzi schemes collapsing [14]. Additionally, Ponzi schemes often fall due to multiple investors calling in redemptions on their investments, which is what happened in the Bernie Madoff case [10]. Lastly and not very surprisingly, many Ponzi schemes collapse due to greed and excessive spending by the fraudsters. Even with continual investors and money flowing in, when fraudsters become obsessed with excessive spending and take too many risks, they may not be able to provide the appropriate amount of falsified returns to investors, thus leading to frustration on behalf of clients and eventually more calls for redemption.

Others assert that eventually, Ponzi schemes will collapse in due time, regardless of how careful fraudsters are with the money and how many new investors come into the network. This is due to the demand that will continue to accrue, with a growing number of investors requiring payments and the limited amounts of new income flowing into the scheme to pay them all [17]. As a result, Ponzi schemes are essentially doomed from the very start and will eventual meet their demise; the problem is that the frauds typically leave many financial causalities and victimized investors in their wake. The schemes also can be more devastating, because they are very difficult to unmask and can last for decades before finally collapsing [17]. Since the elaborate schemes are very difficult to take down, it is essential for investors, regulators, auditors, and investigators to fervently review and take heed to red flags and warning signs. Unfortunately, in most cases and in the case of the Madoff

scheme, greed persuades investors to ignore reasonable decision-making, while reputation and legitimate appearance convince regulators to turn their heads the other way. In the next section the researchers will provide a thorough analysis of how these factors allowed Madoff to successfully con investors out of billions of dollars, while successfully alluding the Securities and Exchange Commission (SEC) using a basic investment scheme that dates back to the mid 1800's.

2. The Bernie Madoff Ponzi Scheme

Bernie Madoff's $65 billion Ponzi scheme will go down as one of the largest acts of fraud in American history. The fraud stemmed from a hedge fund that portrayed Madoff as an investment genius, due to his consistent returns. However, when $7 billion worth of redemptions were demanded by investors at the same time, it was revealed that Madoff was not a mastermind investment genius, but a fraudulent con artist [10]. Madoff had successfully fooled extremely savvy investors, charitable organizations, and large investment funds by operating what is termed a Ponzi scheme, which essentially is the act of collecting money from multiple investors, and redistributing the funds to previous investors as if they are legitimate investment returns (SEC, 2012). The fraud is structured in a manner that requires the scam artist to continuously receive new investments from others, so that the money can be redistributed to previous investors as returns.

As previously mentioned, various factors can quickly cause Ponzi schemes to collapse; a lack of investment funds flowing into the network, an unstable structure, excessive spending by the perpetrator(s), or too many requests for redemptions from investors. The latter is what truly caused Madoff's master plan to come crashing down. As the market began to slow in other areas (Madoff's fund magically was not impacted by the market downturn, which should had been a red flag), investors started to call for a redemption on their funds, probably in an effort to move money around and become more liquid. When too many redemption requests came in, Madoff did not have the liquidity and funds available to meet the calls and thus his actions were uncovered.

3. SEC Missteps and How to Keep History from Repeating Itself

Madoff was operating a hedge fund, which is a limited partnership of investors that uses very speculative trading methodologies. Further, hedge funds have very lenient reporting requirements when compared to other types of public investments and thus it is more difficult to uncover wrong-doing. However, even despite the limited reporting and regulatory nature of hedge funds, the SEC still had ample opportunity to intervene and uncover Madoff's corruption. They received several reliable tips from financial experts, complaints, two articles were published in reputable magazines questioning Madoff's hedge fund (Ascot Partners), and the fund manager received unexplained, consistently high returns that were out of the ordinary for any other hedge fund or investment vehicle [15].

When the SEC received the tips/complaints from reliable financial experts and also analyzed the other red flags, they should have conducted thorough examinations using the Hypothesis-Evidence Matrix to develop a framework [9]. Using this model, they could have created and tested multiple hypotheses regarding the fraudulent activities taking place at Ascot.

Using these methods the SEC investigators may not have completely understood the entire Ponzi scheme nor had all the proof required to take Madoff to trial, but they definitely would have possessed a tested framework depicting that there was a need for further investigation. After formulating, testing, and refining the hypothesis, a more formal investigation could take place using the Evidence-Gathering Order methodology [9]. Using this method, the investigators would have eventually obtained financial records depicting that Madoff was not engaged in actual market trading, but instead was running a vibrant scheme. They would have uncovered that Madoff's sons, who were also executives at Ascot were not leaders in the fraud and that Madoff was the mastermind leading the effort.

Without a formal, methodical approach to fraud examination, elaborate and well-structured Ponzi schemes, such as Madoff's, will not be revealed. This was one of the major mistakes that the SEC made, they conducted lukewarm investigations. Inspector General investigator David Kotz was quoted by Fraud Magazine author, Carozza [2] by stating:

> The SEC did take substantive action [after the complaints] in that they conducted numerous examinations and investigations of Madoff's firm. However, we determined that these examinations and investigations were not conducted in a thorough and competent manner and were, therefore, unable to uncover the Ponzi scheme.

The SEC also had inexperienced staff working the Madoff investigation and lacked adequate guidance and leadership from managers [2]. Essentially, the SEC, which is extremely understaffed, left an investigation that had received, according to some reports, as many as thirty credible red flags, in the hands of new or inexperienced examiners and did not offer proper oversight.

Ultimately, one of the major mistakes that the SEC seemed to commit during this entire situation is they did not recognize and follow-up on the red flags. In the Office of the Inspector General's (OIG) investigative report, it is evident that the SEC ignored the red flags and conducted haphazard reviews, never following through or taking a systemic, methodological forensic financial approach. It is easy to critically analyze after the story has been told, but after reviewing the material, it is clear that the SEC did not do all that they could and should have done and they essentially could have cost thousands of Americans, billions of dollars, due to their ineffective forensic financial accounting methods.

Although it is a horrible method of learning, it is hard to deny that after an incident such as the Madoff Ponzi scheme, that investigators, organizations, and regulators will not leave with more insight, improved methods, and a host of lessons learned. As a result of the OIG's

investigations into the SEC's examination failures regarding Madoff, 69 recommendations have been made and accepted by the SEC and are in the process of being implemented. The researcher will now provide his own recommendations that were cultivated by literature review:

1. Potential customers should thoroughly read prospectuses, follow-up with supposed funds and investment vehicles being used by the hedge fund manager, and avoid investing with organizations that promise guaranteed, unrealistic, or quick returns.
2. Customers should make note of any red flags and immediately report them to regulators or officials for investigation.
3. Investigators should thoroughly follow-up on all red flags.
4. Auditors, investigators and examiners should be thoroughly trained and have senior-level oversight (micro-management may be necessary).
5. Investigators should use multiple investigative models, methodologies, and strategies while conducting examinations.
6. Investigators should utilize teams, with various backgrounds, strengths, and areas of expertise being leveraged, to reduce error, provide cross-checking, and improve reviews.
7. A third-party verification team from the OIG should be used, to cross-check the SEC investigations [2].
8. Specialized units that have expertise in complex cases, forensic accounting, and US laws should be utilized for large investigative cases and those that have an increased amount of red flags and probability of fraud [2].

Utilizing these strategies, investors can drastically decrease their probability of being victims of a Ponzi scheme and investigators will be prepared to rapidly respond to keep the probability of another Madoff incident from occurring.

Since the Madoff scheme, the SEC has taken many steps to improve their operations, investigative processes, and ability to open up legitimate investigations based upon red flags and tips. The agency has also increased their training, development, and recruiting efforts, focusing on investigative financial and accounting experts who can conduct more thorough, accurate, and concise investigations, even for those employees that are only involved in "back-office" activities [16]. This is a major step in the right direction, because previous red flags and tips from internal or external sources were not acted upon, because initial reviews or policies hindered investigators from opening formal review cases.

The SEC has also embraced more of a team-based model to investigative activities. They, like other agencies are leveraging more cross-functional teams who have specialists from different backgrounds, agencies, and disciplines to provide more in-depth investigations [16,18]. On-going and continuous risk-based investigations of financial institutions are common practice now as well, which is more of a proactive approach to uncover fraudulent activities. Instead of waiting for tips or blatant red flags, the SEC is opening initial reviews with a small team of analysts for firms that have certain risk factors/characteristics, which could be alluding to either fraud or a mishandling of funds due to excessively risky processes [16]. Some of the specific steps that have been taken by the SEC to improve their investigations following the Madoff Ponzi scheme include:

- Revitalizing the Enforcement Division
- Revamping the handling of complaints and tips
- Encouraging greater cooperation by 'insiders'
- Enhancing safeguards for investors' assets
- Improving risk assessment capabilities
- Improving fraud detection procedures for examiners
- Improving internal controls
- Advocating for a whistleblower program
- Integrating broker-dealer and investment adviser examinations
- Enhancing the licensing, education and oversight regime for 'back-office' personnel [16].

These actions are certainly steps in the right direction and represent a move from reactive or hesitant investigative behavior, to more collaborative, transparent, proactive investigative behavior that not only seeks to uncover fraudulent activities, but also detect and regulate excessively risky investment behaviors and decision-making by firms.

4. How Organizations Can Detect and Prevent Fraud Internally

The Madoff scenario helped to shed light on some of the fraudulent behavior schemers engage in. While an organization (such as Madoff's empire) can be constructed with the pure intention of engaging in fraud, there are still opportunities to uncover Ponzi schemes (externally), or other fraudulent behavior within larger firms that have not been constructed solely for the purpose of engaging in fraud. As such, obtaining lessons learned from this particular scenario can contribute to improved activities, measures, standards, and processes to prevent similar activities, or other fraudulent behaviors (which are not exclusive to Ponzi schemes alone). This section presents various internal control techniques that can help mitigate the risks associated with fraudulent behavior, while offering external review strategies that can be leveraged to uncover red flags sooner or prior to making large-scale investments.

Fraudulent activities have continued to increase in both the number of incidents and the financial losses incurred for organizations and victims. According to the Association of Certified Fraud Examiners (ACFE), fraud cost organizations more than $990 billion in 2008 [9]. During that same year of the of ACFE study, the unprecedented Ponzi scheme by hedge fund manager, Bernie Madoff, left millions of victims impacted and accounted for $50 billion in financial losses. Due to the increased occurrence and size of fraudulent activities and schemes, it is necessary for organizations to not only have the proper investigative capabilities in place after an incident has occurred, but instead to take a proactive approach to fighting fraudulent activity and ensuring that their organization is equipped with strategies to safeguard stakeholder's interest and assets.

Fraud detection methods are one of the primary ways to uncover fraudulent activity and thus, the quicker an

organization can determine fraudulent activity or attempts, the more they can reduce potential losses. Organizations can create more effective auditing plans by using multiple techniques, modifying strategies frequently, and using a team-based approach to fraud prevention/risk management [8]. Additionally, organizations should put restrictions in place and offer opportunities for peer/organizational cross-checking, while utilizing forced vacation policies [9]. Opportunities for early fraudulent detection occur when employees/executives are engaged in team atmospheres and are not left with complete autonomy, especially when they are in positions that have easy access to their organization's finances. By vigilantly seeking to uncover illegal or unethical activity and using multiple resources and strategies, organizations can significantly increase their opportunities of discovering fraud, prior to incurring excessive losses.

In this modern society, organizations should seek to leverage technology to reduce fraud. In the case of the University of Iowa Credit Union, they utilized a software program to uncover credit card fraud activities quickly, providing them with the opportunity to step in to remedy the situations before incurring unnecessary losses. Using the software programs, the credit union experienced a 41% reduction in fraud losses. Forensic accounting experts may argue that fraud detection and examination requires critical thinking and cannot truly be executed by technological systems. While trained forensic financial professionals and fraud examiners are required to conduct accurate critical analysis, organizations can still utilize technological systems to generate data and identify potential red flags in a quick and efficient manner, allowing the trained professional to focus on thoroughly analyzing these potential tips in more detail.

From the literature review it seems clear that in order to institute effective fraud prevention programs, organizations should focus on improving detection techniques. The strategies highlighted in this review were:

- Use multiple auditing techniques
- Use team approaches to auditing
- Utilize employee/executive peer cross-checking and teams
- Leverage technology to identify red flags

5. Utilizing Fraud Examination Experts on Corporate Boards

Most major organizational schemes will often involve some form of financial statement and forgery fraud, so understanding the red flags to look for, while practicing sound examination techniques are truly important [5]. However, in an effort not to minimize the responsibility of auditors and investigators, it is very important for organizational directors to also protect stakeholders' interest, by ensuring that financial statement fraud is not prevalent in organizations [6]. Unfortunately, many board directors lack the knowledge, skill-sets, and capabilities required to properly review financial statements and ensure that fraud is not present.

As such, one of the first steps that should be taken to address financial statement fraud is to ensure that organizations are selecting feasible directors within their firms or non-profits to provide thorough analysis. By embracing this aspect, organizations can put themselves in a position to proactively reduce the opportunity that their entity will become victims of financial statement fraud. As the researchers have pointed out in other commentaries regarding financial statement fraud and governance, oftentimes the processes and techniques are not necessarily the issue, but instead, the individuals (board of directors) responsible for detecting fraud are not equipped with the knowledge to thoroughly carry out examinations and oversee checks and balances [4]. These statistics are evident after reviewing the failed policy attempts of Sarbanes-Oxley section 404. Moreover, directors often find themselves relying too heavily on auditors to detect financial statement fraud, when this process truly is not meant to be the first proactive level of financial statement review, but instead serves as an additional secondary checkpoint, following the board's research.

One can argue that organizational directors often do not discover financial statement fraud, due to their convoluted financial interest and focus on earnings. For instance, one study found that the likelihood of undetected fraud within an organization being missed by board directors increased, with the amount of financial interest/stock-options that the directors had in the organization [12]. This is relevant, because essentially these results potentially can allude to the notion that as directors' financial interest in the organization increase, the more likely they are to ignore their responsibilities of governance and focus on "revenue generating" activities that pertain to strategy, R&D, managerial directions, and so on.

In essence, these directors misunderstand the fact that when they do not provide accurate governance and ignore oversight procedures and succeed at reducing the likelihood of fraud taking place, they diminish the value of their own investments and fail to fulfill their obligations to stakeholders. When financial scandals occur, it can set the company back several years and even risk putting the organization completely out of business. As a result of this literature review, the researchers' recommendations are two-fold:

1. Hire directors on boards that have the skill-sets, knowledge, and desire to engage in forensic accounting, examination, and auditing practices to ensure that financial statement fraud is prevented prior to external audits.
2. Offer incentives and directly link directors' compensation and responsibilities to financial governance and fraud prevention/detection. This can be done by offering bonuses for financial fraud discovery, detailed examination processes/checklists that must be signed off on (similar to SOX).

6. Conclusion

The Bernie Madoff Ponzi scheme made history due to the enormous size of the fraudulent act. The fact that the SEC conducted numerous reviews or ignored tips to investigate the organization more in-depth, and was never able to conclude that the organization was a Ponzi scheme proves that investigative practices and acts were lacking, and follow-up investigations into the SEC's probe helped

to solidify these findings [7]. In this critical analysis of the Madoff scheme the researcher provided a detailed review of the missteps taken by the SEC, along with steps the agency has since taken to improve their investigative processes. Additionally the researcher extrapolated lessons learned from the Madoff incident and provided a framework that can assist investors, fraud investigators, and organizations with discovering and preventing corporate fraudulent acts in general, even if they are not Ponzi schemes.

The researcher concluded that a comprehensive approach to fraud detection and prevention is necessary to truly address the issue and prevent future schemes. By embracing a preventive and proactive model rooted in investigative principles, organizations can drastically reduce exposures to risk and provide their organization with accurate risk management and mitigation principles. Utilizing these strategies, organizations, investors, and oversight agencies can potentially reduce the number of fraudulent occurrences and protect the investments and assets of their various stakeholders.

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