

Before and After Bernie: 
Ponzi Regulation or Lack Thereof?

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ABSTRACT

In 2008, one of the largest Ponzi schemes ever was uncovered, and the financial community has been reeling ever since. Bernard Madoff cheated investors out of more than 50 billion dollars, and investors are left to wonder how it happened, what can be done to recoup and account for losses, and how to prevent future schemes from occurring. In the early days after news of the scheme became public the media began playing a blame game, focusing in on the accounting profession (specifically auditors), the Securities and Exchange Commission and other regulatory bodies, as well as the investors themselves. This paper reviews the history of Ponzi schemes, the role of accounting and auditing in both perpetrating and unearthing these schemes, the role of the SEC and the role of the investor. In conclusion, this paper will suggest changes to regulation, procedure, and investor due diligence so that investor faith and confidence will be restored in the market and legitimate investments.

Before and After Bernie; Ponzi Regulation or Lack Thereof?

Introduction

In 2008, the financial community was turned upside down as one of the largest Ponzi schemes ever was uncovered. Bernard Madoff cheated investors out of more than 50 billion dollars, and investors are left to wonder how it happened, what can be done to recoup and account for losses, and how to prevent future schemes from occurring. Since the Madoff scheme became public knowledge, many other schemes have come to light and the media has been playing a blame game ever since, focusing in on the accounting profession (specifically auditors), the Securities and Exchange Commission and other regulatory bodies, as well as the investors themselves. This paper will review what a Ponzi scheme is, the history of Ponzi schemes, the role of accounting and auditing in both perpetrating and unearthing these schemes, the role of the ~~IRS, SEC and~~ other regulatory bodies as well as the investors themselves. In conclusion, this paper will suggest changes to regulation, procedure, and investor due diligence so that investor faith and confidence will be restored in the market and legitimate investments.

The History and Background of Ponzi Schemes

Long before Bernie Madoff, men and women have defrauded the general public as well as sophisticated investors with the use of Ponzi schemes. Some fraudsters had flashy names, such as William "520 percent" Miller and RaeJean "Rapmaster 20K Percent" Bonham. Others used sophisticated or official sounding titles such as "Foundation for New Era Philanthropy" and "Mutual Benefits Company". What they had in common was a dishonest attempt to defraud investors to fund their lavish lifestyles.

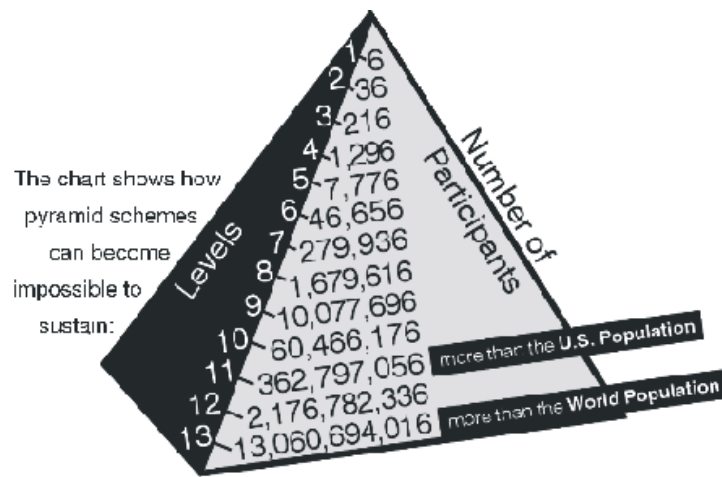
What is a Ponzi scheme? Ponzi schemes ~~are described as~~ work on the "rob-Peter-to-pay-Paul" principle, as money from new investors is used to pay off earlier investors until the whole scheme collapses. (SEC.gov). ~~"a fraudulent investment operation that pays returns to separate investors from their own money or money paid by subsequent investors, rather than from any actual profit earned" (wikipedia.com).~~

Ponzi schemes are distinguished from Pyramid Schemes in that with Pyramid Schemes:

participants attempt to make money solely by recruiting new participants into the program. The hallmark of these schemes is the promise of sky-high returns in a short period of time for doing nothing other than handing over your money and getting others to do the same (SEC.gov).

In one sense, Pyramid schemes are more candid, in that they typically reveal to the investor the method of financial gain, which is to recruit new investors. Ponzi

schemes on the other hand, delude investors into believing that their money is being invested in high yield vehicles, and that their gains are derived from gains on investments, and not the recruitment of new investors. As the Securities and Exchange Commission points out, Pyramid schemes, of which Ponzi schemes are a subset, collapse under their own weight and are unsustainable.



Source: SEC.gov

The chart above demonstrates the fact that pyramid and Ponzi schemes are, by their very nature, unsustainable. The schemes need to recruit new members and new money into the fraud. Those members must then recruit new members in order to sustain the fraud. There simply are not enough new members, or new money, available to sustain the fraud in perpetuity. In fact, the growth in funds and/or members must be exponential in order to sustain the fraud. But as the chart above demonstrates, if each new member

needs to recruit just ~~six~~6 others to sustain the fraud, then by going a mere 11 levels deep, a pyramid/Ponzi scheme would have to recruit a number of investors into the fraud that exceeds the entire population of the United States. This is unrealistic to say the least. By level 13, the scam would need to recruit more persons than exist on the planet. Again, an obvious flaw in the sustainability of the pyramid. Whether recruiting new members (pyramid) or new monies (Ponzi) the results are the same. The fraud is simply not sustainable over the long term.

Who was Charles Ponzi?

Carlo "Charles" Ponzi was an Italian who, at the age of 21, emigrated to Boston in 1903. He was in trouble with an Italian crime syndicate and fled to America to save his skin. After working a series of menial jobs for more than ten years, including a few brushes with the law for check forgery and attempting to smuggle other immigrants into the United States, Ponzi stumbled upon his grand scheme.

According to Clikeman (2009), Ponzi received a letter from a friend in Spain, which contained a postal reply coupon. Postal reply coupons were created by t~~At that time, 1919, t~~he United Postal Union (UPU) which was established in 1874, an organization established in 1874, with its Headquarters in Berne (Switzerland), to aid cooperation between postal-sector players (upu.int). Headquartered in Switzerland, the UPU, permitted customers to buy coupons redeemable in another country for stamps.

Therefore, one could send coupons along with a letter, so that the recipient could purchase stamps in his or her own country, and reply to the letter. Ponzi calculated that coupons purchased in Italy were worth six times as much in the US as a result of a

devaluation in Italian currency. Thus Ponzi planned to send money to his friends in Italy to purchase the coupons and [then he would](#) redeem the coupons in the US for stamps. He would then sell the stamps at a discount to businesses. Ponzi began advertising his plan, promising to pay a 50% return in 45 days and soon was collecting millions of dollars for his scheme. The [then-](#)publisher of the Wall Street Journal calculated that in order for Ponzi to be legitimate, he would need to be purchasing millions of dollars worth of stamps. Yet, there were only 27,000 postal reply coupons in circulation, ~~according to (-Clikeman, -(2009).~~ Ponzi's scheme collapsed ~~whenafter~~ investors demanded their funds after word got out, ~~Ponzi and subsequently~~ spent the next several years in prison.

While Ponzi lent his name to the scheme, he was not the originator of the idea to pay off old investors with new monies in a scheme to defraud. In fact, Charles Dickens wrote about such a scheme in his 1857 book, "Little Dorrit". In 1899, William "520 percent" Miller promised investors a 10% return per week with a "sure pull" on Wall Street. Investigators brought down his Franklin Syndicate, and Miller admitted "that all of the payouts came from other investors' money, and none from actual profits (New York Times December 15, 2008).

In modern times, fraudsters have perpetrated the Ponzi schemes across the globe. Ponzi schemes have been reported in India, Russia, Portugal, South Africa, Jordan, Romania, Albania, Haiti, Costa Rica, Malaysia, Philippines, and in numerous states in the US. The frauds range in cost from a few million to multiple billions of dollars. The perpetrators are rags to riches types, as well as established persons with seemingly good reputations, such as Bernie Madoff (~~founder~~ [former chairman](#) of

NASDAQ) and Lew Pearlman (Boy Band mogul). Their victims range from nain naive investors looking to make a quick buck, to sophisticated investment professionals desiring to beat the market for their clients. Greed and a willing suspension of disbelief are traits of some investors.

A recent article in the Sunday Times pointed out the following characteristics of a classic Ponzi scheme:

THE BAIT: The fraudster most often lures investors with promises of above-market returns.

THE HOOK: The above-market returns are most often explained by complicated fictitious business models

THE LINE: The fraudster is almost always a persuasive, well-respected or well-connected person.

THE SINKER: Little or no commercial activity actually ever takes place (2009).

Regulation or Lack Thereof

The Security and Exchange Commission

Recently, Bear Stearns, Lehman Brothers, Madoff Securities and others have failed leaving their investors not only with significantly less wealth, but wondering how these failures could happen. Is it possible that defrauding investors is a new concept? Are Ponzi and affinity schemes too complex to be detected by regulators? In fact, are there regulators?

Defrauding investors is nothing new, Ponzi and affinity schemes are not complicated beyond detection, and yes, there is a regulatory body. The Securities and Exchange Commission (SEC) was created in 1934 as a result of Congressional hearings following the stock market crash of 1929 that led to the Great Depression. The Securities Act of 1933 and the Securities Exchange Act of 1934 (which created the SEC) were implemented to restore investor confidence by providing complete and honest disclosure as well as regulation regarding honest dealing. The SEC website reduces the two laws to the following simple paragraphs:

Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.

People who sell and trade securities – brokers, dealers, and exchanges – must treat investors fairly and honestly, putting investors' interests first (SEC.gov).

The SEC is made up of five commissioners, four divisions, nineteen offices, and some 3500 employees. The SEC is charged with the following responsibilities:

- Interpret federal securities laws;
- Issue new rules and amend existing rules;

- Oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies;
- Oversee private regulatory organizations in the securities, accounting, and auditing fields; and
- Coordinate U.S. securities regulation with federal, state, and foreign authorities (SEC.gov).

Having established that defrauding investors is not a new concept, that Ponzi and affinity schemes are not complex beyond detection, and that there is a regulatory body (a large one at that), why have schemes such as the one perpetrated by Bernie Madoff (Madoff Securities) gone undetected? Investment sophistication is one of the primary issues at the heart of the recently uncovered investment scandals (Westlaw, 2007).

There are six primary laws that govern the securities industry in the United States:

- Securities Act of 1933
- Securities Exchange Act of 1934
- Trust Indenture Act of 1939
- Investment Company Act of 1940
- Investment Advisers Act of 1940
- Sarbanes-Oxley Act of 2002

Three of these laws are pertinent to the recent rash of Ponzi and affinity schemes, their regulation, or lack thereof:

The Securities Act of 1933 (Truth in Securities Law) requires that investors receive financial and other information concerning securities for sale, and prohibits

deceit, misrepresentations, and other fraud in the sale of securities. This information is disseminated by way of security registration which allows the investor to make informed decisions regarding their investments. It is important to note that the government does not make decisions on investments, nor does it guarantee the information disclosed to be accurate (although the SEC requires it to be accurate). It is also important to note that not all securities have to be registered; for instance, private offerings to a limited number of persons or institutions and offerings of limited size.

The Securities Exchange Act of 1934 created the Securities and Exchange Commission, empowered to register, regulate and oversee the securities industry. This act also requires that companies with publicly traded securities periodically report information.

The Investment Company Act of 1940 oversees the organization of companies that engage in investing, reinvesting, and trading of securities. The act requires that companies disclose their financial information and investment policies to potential investors when stock is initially sold, and periodically thereafter on a regular basis.

Despite, or because of the security laws addressed above, investment sophistication is indeed at the heart of the recent investment scandals. The Securities Act of 1933 and subsequent amendments introduced the concepts of “accredited investor” and “sophisticated purchasers”, while the Investment Company Act of 1940 introduced the concept of “qualified purchaser.” The designation of accredited investor or sophisticated purchaser is assigned to individuals, while the designation of qualified purchaser is assigned to investment firms, including hedge funds. In all cases, the designation is intended to demonstrate that the investor or firm is highly educated and

informed about the market, has sufficient financial capacity, performs their own due diligence, and recognizes the risks associated with investments. In other words, those possessing these designations are capable of taking extraordinary risks to garner extraordinary returns.

Under the Investment Company Act of 1940, hedge funds are specifically exempt. In other words, they are not required to provide investors with financial information and investment policies, nor are they required to do so periodically (Sec. 80a-6(A)(5)(iii)). The thought process, obviously flawed, is that the hedge fund can pursue more aggressive proprietary investment policies to obtain higher returns for their clients without disclosure. On the other hand, the status awarded investors through the Securities Act of 1933 (Rule 501) assumes that the investor has the market savvy to ask the appropriate questions, the financial capability to assume risk, and to perform the due diligence associated with the more risky investments (University of Cincinnati). The legislation concerning hedge funds and sophisticated investors is quite clear as discussed above. However, the regulation, or lack thereof, is more complicated than it seems.

In the original version of the Investment Adviser's Act of 1940, all persons or firms advising 15 clients or more during the previous 12 month period were required to register with the SEC. However, a client was defined in a manner that made it somewhat easy to avoid registration, as that any legal organization was counted as one client, regardless of the number of individual clients making up that organization. Those that are required to register under this act are subject to very specific rules regarding limitations on fees, custody of funds, books and records requirements, ethical

standards, compliance standards, and are subject to SEC inspection and sanctions (Schubert, 2005).

The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board (PCAOB) which requires accounting firms that audit publicly traded companies to register with the board. The auditors of Madoff Securities did not audit public companies, and therefore were not required to register. However, brokerage firms are required to be audited by PCAOB registered auditors, so it would seem that in the Madoff instance the rules were violated. ~~Don-Madoff's broker-dealer entity did have an audit (a fraudulent one).~~ Unfortunately, the SEC exempted private brokerage firms from this regulation as a privately held firm most often has few investors that need audited financial statements. Madoff's broker-dealer unit did, in fact, have an annual audit albeit a fraudulent one. The SEC extended this exemption several times, stating that allowing such firms not to register was "consistent with the public interest and the protection of investors" (New York Times, 2009). In 2009, the PCAOB announced that accounting firms must now register with the board if they are auditing broker-dealers; however, the PCAOB is only empowered to regulate public companies and their auditors. In other words, audits of non-public broker-dealers as other private company audits are still not subject to regulation, regardless of whether or not the accounting firm is registered with the PCAOB (~~Soxonline.com~~). Within the Sarbanes-Oxley Act, there are two provisions that could have done a great deal to deter the Madoff Ponzi scheme, had it not been for the exemption noted above. First, the requirement that corporations develop codes of ethics for senior financial officers that include, among

other things, enforcement mechanisms (Section 406) and second, the requirement that outside auditors be rotated on a regular basis (Sections 203 and 207) (Orin, 2007).

Franklin Edwards presented a paper to the Atlanta Federal Reserve in 2006 that sums up the regulation of hedge funds nicely:

In the United States the regulation of hedge funds might be best characterized as a patchwork of exemptions from various investor protection laws rather than a thoughtfully crafted top-down or bottom-up regulatory scheme. The United States neither requires government authorization of hedge funds nor restricts what hedge funds are able to do, nor does it mandate that hedge funds and hedge fund advisers make specific disclosures to investors. But to gain these exemptions hedge funds must restrict their clients to investors who meet certain threshold wealth or income requirements. Qualifying investors are given unlimited access to hedge funds with virtually no regulatory protections, while low-wealth or low-income investors are entirely excluded from participating in any kind of hedge fund investment (Edwards, 2006).

~~Need to look at the SOX act more closely here.....then can go into ethics and auditing procedures, GAAP and so on? Does the IRS have a role in the prevention? What is the investor responsibility regarding due diligence?~~

Auditors and the Accounting Profession

Hedge funds are not required to have an annual audit. ~~if however~~ if, however, a hedge fund is also an investment advisor, then it needs to register with the SEC and would therefore need to have an annual audit.

Technically, ~~however~~, Madoff was not running a hedge fund; however, he was an investment advisor (-broker) who was paid through commissions rather than fees and a cut of the profits. Regardless, his massive scam will help deal a heavy blow to many hedge funds and fund of funds, as well as to other professionals who steered powerful clients into his hands. Madoff He encouraged the perception that he was running a hedge fund when, in fact, he was directly depositing his investors' funds and those of the feeder funds directly to his bank account. He then used the bank account for investor redemptions from his "fund" as well as for personal expenses (such as purchasing a yatchyacht) ~~as well as for investor redemptions from his "fund"~~. There is no record of even a single investment trade having been being made on behalf of his investors.

~~Having said that,~~ Madoff did have an accounting firm perform an audit on his broker-dealer business annually. -The audit was performed by the firm of Friehling & Horowitz. Why didn't the auditors discover the fraud?

Friehling & Horowitz is a three-person accounting firm that is operated out of a 550 square foot office in Rockland County, New York (New York Times, December 25, 2008) . On March 18, 2009 the SEC charged the firm "with committing securities fraud

by falsely representing that they had conducted legitimate audits, when in fact they had not" (SEC.gov).

The SEC's complaint alleges that Friebling & Horowitz aided Madoff in his fraud by claiming that they had performed the audit in accordance with Generally Accepted Auditing Standards (GAAS), when they had not done so. The complaint further alleges that the firm represented the financial statements of Madoff's broker-dealer firm were prepared in accordance with Generally Accepted Accounting Principles (GAAP) and that it had reviewed the firm's internal controls and found no material weaknesses. "The SEC's complaint alleges that all of these statements were materially false because Friebling and F&H did not perform a meaningful audit of **Bernard Madoff Investment Securities (BMIS)**, and did not perform procedures to confirm that the securities BMIS purportedly held on behalf of its customers even existed" (SEC.gov). Thus, Madoff's auditors merely gave the appearance of having performed an audit.

———Auditors are required to be independent of the firms that they audit. Specifically, the AICPA's Code of Professional Conduct requires auditors to be "independent in the performance of professional services" (AICPA Code of Professional Conduct, Rule 101 --Independence, Section 101.01, AICPA.org). Further, the AICPA Code of Professional Conduct states: "Independence shall be considered to be impaired if...a member... had or was committed to acquire any direct or material indirect financial interest in the client" (AICPA Code of Professional Conduct, Rule 101 --Independence, Section 101.02, Interpretation of Rule 101, AICPA.org).

According to the Wall Street Journal, "the SEC ... alleged that Mr. Friehling and his family had investment accounts at the Madoff firm worth more than \$14 million, a "blatant" conflict of interest that violated auditing rules, according to the complaint. He and his family withdrew at least \$5.5 million since 2000, the SEC said" (Efrati, A., March 19, 2009, pg C. 1). Clearly Mr. Friehling, if the allegations are true, was in gross violation of the Independence standard.

All firms that perform audits are required by the AICPA to be peer reviewed by other audit firms (AICPA Peer Review Program, Questions and Answers, AICPA. Org). At present, "Over 30,000 firms are enrolled in the AICPA Peer Review Program" and they are "required to have a review of its accounting and auditing practice at least once every three years" (AICPA Peer Review Program, Questions and Answers, AICPA. Org). Why didn't the peer reviewers of Friehling & Horowitz discover the shoddy or non-existent audit work?

Friehling & Horowitz claimed in writing, for a period of 15 years, that it did not perform audits. According to the Wall Street Journal, " David Friehling, the firm's only active accountant, was enrolled in a peer-review program at the American Institute of Certified Public Accountants, but wasn't required to participate because he told the trade group that he didn't handle audits, according to the AICPA" (Wall Street Journal Asia, February 19, 2009). Thus, Madoff's auditor avoided the requirement that all firms that perform audits be peer reviewed, merely by claiming it did not perform audits and was therefore exempt from having to submit to the peer review process.

If however, the hedge fund is also an investment advisor, then it needs to register with the SEC and would therefore need to have an annual audit. Why didn't the SEC

discover the fraud sooner?

For many years Madoff's investment advisory service was unknown to the SEC.

Madoff had not registered with the SEC as an investment advisor. Therefore, the SEC knew only about his broker-dealer business. In fact, when the SEC conducted its bi-annual audits of Madoff's broker-dealer firm, which was located on the 18th and 19th floors of Manhattan's Lipstick building, it was completely unaware of the Ponzi scheme being perpetrated from the 17th floor of that same building. Madoff was committing fraud literally right under the noses of the SEC. Until December 2008, BMIS was a broker-dealer registered with and regulated by the US Securities and Exchange Commission (SEC), five self-regulatory agencies (such as the US Financial Industry Regulatory Authority, or FINRA) as well as ten US states and territories. In addition, from September 2006, BMIS was registered with the SEC as an investment adviser. Press reports indicate that in the last 16 years, the SEC and other regulators examined BMIS on-site at least eight times. The SEC twice met face-to-face with Bernard Madoff. But despite extensive contact and regulation, officials failed to uncover BMIS's \$50 billion fraud that Madoff revealed in mid-December 2008 and which now appears to stretch back over a decade (Schwartz & Katz, 2009).

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Further, when the SEC began investigating funds that acted as feeders -to Madoff, Madoff initially claimed to have fewer than 15 clients. With fewer than 15 clients, Madoff did not need to register with the SEC. Of course, Madoff was lying. He had many more than 15 clients, but he required each client to sign a confidentiality agreement stating they would not disclose that Madoff was investing money for them. During an investigation in 2006, the SEC discovered that Madoff had more than 15 clients. At that time, the SEC required Madoff to register with the SEC, and closed its investigation.

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performed. Madoff, however, was running a legitimate broker-dealer firm that was audited by Fricling & Horowitz.

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What about the investors? Why didn't they discover the fraud? After all, some investors were feeder funds with great financial expertise. Others were wealthy individuals, some were even celebrities, such as Kevin Bacon and Steven Spielberg. Why didn't any of these investors, presumably sophisticated enough to make their millions in the first place, discover the fraud? Further, were there potential investors, individuals and financial institutions, who did due diligence and opt not to invest?

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Hedge funds are not required to disclose their results, strategies, or holdings. An article in the Journal of Accountancy warns its readership, which consist primarily of practicing Certified Public Accountants, "CPAs used to the vast amounts of information available about mutual funds will find some critical differences. Because hedge funds

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are private, they aren't required to report returns, don't generally have to disclose their security holdings and sometimes lock up investors' money for a year or more. In contrast, mutual funds post their net asset values daily, disclose their holdings quarterly or semiannually and can easily be bought and sold on a daily basis" (Bernstein, May 1, 2002). Indeed, Madoff refused to disclose any of this information as he claimed it would reveal his secret strategy to his competitors. When pressed by current and potential investors, (Madoff talked vaguely about ~~conducted~~ a strike-split strategy on options on the stocks ~~in~~ the S&P 100.) This strategy was complicated enough to seemingly discourage follow up questions by most current and potential investors, as they would not have understood it anyway.

Feeder funds would whisper that they had special access to Madoff; investors would give their money to the feeder funds, who would then invest the money with Madoff. Each investor thought he or she was gaining special access that others did not have. In truth, Madoff was growing increasingly desperate to obtain funds to support his huge Ponzi scheme. But the rarity of access served to diminish the perceived need for due diligence. After all, if all these other sophisticated investors were investing in Madoff, he must be legitimate.

What's more, the world of hedge funds is ~~both~~ murky. ~~It is often and hush-~~ hush. Hedge funds are not allowed to advertise. ~~and~~ They obtain their funds primarily through word of mouth and feeder funds. Madoff was highly secretive. ~~and~~ He instructed his clients not to disclose that he was managing their money. Further, he frequently acted like he did not need their money. ~~ty.~~ This nonchalant attitude ~~serv~~inged

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him well in duping his clients. The more he acted like he did not need the money, the more they wanted to invest. They saw no need to do due diligence. Often times, the older generation, according to Arvedlund, E. (2009), did business on trust and a handshake. It would have been considered almost unseemly by some wealthy investors to ask too many questions (Arvedlund, 2009)

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Further, many investors believed Madoff was cheating, but cheating on their behalf. They suspected that he was front running trades from his broker-dealer business and making money off of his knowledge on the broker side. Thus, they knew he was doing something illegal, but he was doing it on their behalf. So, they looked the other way. They never suspected that he was a total thief.

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Further, the sophisticated people working in feeder funds must have performed extensive due diligence. Didn't they? Some did; some did not. Owners of feeder funds

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~~made tremendous fees for bringing money to Madoff. Their multi-million dollar salaries served as a disincentive for them to ask Madoff too many questions.~~

Others did ask questions and realized Madoff was a fraud. A potential buyer of a Fairfield Greenwich, a significant Madoff feeder fund, hired a banker to do due diligence on Fairfield Greenwich Group (FGG). Because FGG had about 85% of its assets invested with Madoff, the banker turned his attention to Madoff's funds. Madoff provided the banker with a blotter showing trades Madoff allegedly made in the S&P 100 index options. The banker checked the trades in the open market, and if what Madoff had shown him was valid, then Madoff would have been making "82% of all the volume in the S&P 100 index options" (Arvedlund, 2009). A second red flag developed when the banker called colleagues in the Chicago trading pit and said no one had ever heard of Madoff. The third red flag appeared when the banker got the same response from a colleague in the over-the-counter market. How could an investment advisor who claimed to be making 82% of all trades in S&P 100 index options not be known to experts in options trading? The answer is that he did not make a single trade on behalf of his clients.

~~Madoff's fraud was also exposed when he met with Rob Picard of the Royal Bank of Canada (RBC) in 1997. Rob Picard of the Royal Bank of Canada was asked to meet with Madoff in 1997. Some of Picard's clients wanted to borrow funds from RBC and invest them in Madoff, through a feeder fund. Within a few minutes of meeting with Madoff, Picard "realized he had logged hundreds of miles...only to have stumbled into a fraud" (Arvedlund, 2009, p. 90). "Madoff stuttered when he tried to explain his options~~

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strategy, and right away I realized he either didn't understand it, or he wasn't doing what he said he was doing" (p. 90). One would have to wonder why Rob Picard and RBC did not report the fraud at that time. After the meeting, many of RBC's clients pulled their investments out of the feeder fund.

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In an informative article in 2002 which sought to educate CPAs about hedge funds, the Journal of Accountancy warned CPAs about the necessity of doing due diligence with regard to hedge funds. The author warns: "Given the complexity of selecting and monitoring hedge funds, CPAs would be well advised to make sure the client's overall portfolio has a sufficient foundation in other, relatively safe liquid investments. CPAs should also recommend that clients commit assets to any investment--including hedge funds--only after thorough research and due diligence"

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(Bernstein, May 1, 2002). Had Madoff's investors heeded this advice, perhaps they would not have lost their life savings.

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The Investors

It would be very easy to say that the investor is solely at fault for falling into the trap of a Ponzi scheme. Despite the lack of regulation and/or enforcement on the part of the SEC, despite the improprieties on the part of accountants and auditors, and despite suspicious and fraudulent offerings of the hedge funds, hedge fund managers, and fund of funds and their managers, an investor is responsible for his or her own due diligence with any and all investments that they undertake.

Comment [JD1]: Tense agreement. "an investor" is singular, while "their" is plural.

What is due diligence? According to Merriam-Webster, due diligence is "research and analysis of a company or organization done in preparation for a business

transaction (as a corporate merger or purchase of securities)" (2009). The concept of due diligence is a basic tenet of investing, as basic as the concept of diversification. Given the nature of the sophisticated investor, one would think that due diligence would take place prior to any and all investments; however, two things come to mind with regards to the Ponzi and Affinity schemes which have recently been uncovered. First, the investment schemes are supposedly extremely complex and the investment strategy confidential. Second, the concept of greed might come into play.

What is so complex about the strategies employed by hedge funds? Traditional due diligence takes place to ensure that the investor has obtained and utilized all information available to make a sound and rational investment commitment. A hedge fund, by nature, is designed to avoid regulation and subsequent required disclosures. In fact, the offering document for a hedge fund rarely states anything substantive about the manner in which the investor's money will be invested. In general, hedge funds aim to make profits by betting against market prices, and disclosure would ruin their chances of doing so (Cohen, 2009). In other words, a hedge fund strategy may or may not be very complex; however, the hedge fund does not disclose the information making it very difficult for an investor to perform proper due diligence.

Some institutions did perform their due diligence on the Madoff Securities investment. Madoff's strategy was surprisingly simple; timing moves from US Treasuries into the S&P100 (hedged with a split-strike collar). However, to return 10% per year on a regular basis with such low volatility would be extremely difficult to do. Markov Processes International became suspicious during due diligence of Madoff in 2006 and tried to replicate the process, and they found only one asset that replicated the returns

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(Bayou Management, LLC) which began creating their own false returns in 1998 when their own investment strategy failed (Financial Times Professional Wealth Management, 2009). Executives at Mesirow Advanced Strategies Inc. looked at Bayou Management, LLC as a potential investment a few years ago. The close relationship between the broker-dealer and Bayou itself as well as an unknown audit firm were red flags, and Mesirow did not invest in Bayou (Williamson, 2005).

Switzerland's Union Bancaire Privee (UBP) apparently performed their due diligence and were concerned with non-segregation of investment, brokerage and custody functions; however, given Madoff's reputation as a reputable broker-dealer subject to regular SEC and FINRA audits they felt comfortable to invest \$700 million of client money with Madoff through feeder funds (Financial Times Professional Wealth Management, 2009).

William Galvin, the Massachusetts Secretary of State and chief securities regulator, investigated Fairfield Greenwich, the first hedge fund to invest with Bernard Madoff Investment securities and stated that there was a

profound disparity between the due diligence that Fairfield represented to its investors that it would conduct with respect to Bernard L. Madoff Investment Securities [BMIS] and the due diligence it actually conducted ... [We] attempted to discern how Fairfield possibly could not have discovered the fraud during their 18-year relationship [with Madoff]. The answer is that they were blinded by fees, did not engage in meaningful due diligence, and turned a blind eye to any fact that would have burst their lucrative bubble (Seib, 2009).

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Kevin Lecocq, chief investment officer for Barclay's Wealth stated "having submitted Fairfield and Madoff to our comprehensive due diligence program, we concluded that this fund was an attractive opportunity for our clients. Indeed, we believe the merits of the strategy are emphasized by the number of high-quality institutions which invested in the fund." David Green, head of litigation for London-based law firm Edwin Coe stated "It is becoming clear from investigations in America that there were no real investments at all. So how would it be possible for anyone to do due diligence on the fund, as Barclays say they did?" A spokeswoman for Barclays Wealth declined to comment (Watts, 2009, p.14). Randall Etnyre, speaking of due diligence in the housing industry, simply stated "just like a medical exam, the value of the due diligence is based on the quality of the diagnosis" (Etnyre, 2009, p. 33).

Greed on the part of wealthy, sophisticated investors can certainly be attributed to the lengthy success of the Madoff Ponzi scheme, and very few will feel sorry for these individuals. On the other hand, the same cannot be said for the fund of funds, their managers and consultants who are paid a fee (usually one percent fixed and 10 percent of the profits) for exercising exhaustive due diligence, investigating hedge funds and their investment strategies. They have an implied fiduciary responsibility, which they simply did not fulfill. If they also received placing fees from Madoff for sending investment money to his firm their greed is beyond comprehension. The consultants never verified the books and records because there were no books or records, and they never understood Madoff's investment strategy because there was no investment strategy. Although Madoff maintained his strategy was highly sophisticated, tactical trading almost anyone in the investment business knows that there is no such thing and

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even if there was, it could not have gone on for decades without ever experiencing a losing quarter. It is simply inconceivable, and the many professionals who rejected Madoff did recognize this (Biggs, 2009).

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It is also possible to consider that investor's felt that Madoff was doing something that wasn't legal; however, since the illegal actions would benefit them they turned their heads the other way. "A lot of people either saw or got a sense that something was fishy, but thought, 'He's probably front-running but he's front-running for me'," said Jacob Schmidt, CEO of hedge fund advisory firm Schmidt Research Partners, who steered his clients clear after he did due diligence on Madoff feeders in 2003. "What kind of attitude is that? I can understand that a private individual might like that idea, but I cannot accept that from institutional investors" (Financial Times, February 2009, p. 7).

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~~(Don, I agree that the IRS was not at fault. I was wondering why you mentioned it in the beginning. I understand now.)~~ Recommendations

Comment [JD2]: Do we want to do a Problem-solution format? Or, I guess it would be a Loophole-Plug the loophole approach.

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Many variables came together in a "perfect storm" to allow Bernard Madoff to perpetrate his Ponzi scheme for as many years as he did: the majority of investors did not perform due diligence, and those that did and realized that Madoff was a fraud failed to report their findings; the laws, regulations, and secretive nature of hedge funds helped to protect Madoff from detection; many investors, although in doubt of the legitimacy of Madoff's investment strategy/returns were willing to look the other way to achieve higher than normal returns, and investment professionals compromised their professional integrity to achieve higher than normal returns for their clients as well as commissions

and fees for themselves. Although the facts are not totally clear at this point, it is evident that changes are in order to protect both investors and the integrity of the financial community. -One can view the loopholes that Madoff exploited, and then recommend solutions designed to close the loopholes.

Madoff's audit firm was able to circumvent the AICPA's requirement that firms which perform audits be reviewed by their peers, simply by falsely claiming that it did not perform any audits. A way such a fraud might be discovered is by requiring all investment advisors, broker-dealers, feeder funds, qualified purchasers, sophisticated purchasers, and accredited investors to submit the name of their audit firm, as well as the name of the firm that audits their money managers in whom they invest to a national database administered by the SEC. In the interest of transparency, access to this database would be available online to any investor.

Further this database will be designed so that it automatically cross-checks the data for discrepancies. In addition to the automatic cross checking performed by the system, the database will be audited by experts and will compare the name of the firm to records in the SEC, PCAOB, and AICPA.

For example, had this database existed, the name of Madoff's audit firm would have been required to be submitted to the database, by Madoff, by the audit firm itself, and by each investor or potential investor in Madoff (Note: "investor" could be an individual, a feeder fund, or a fund of funds in this example). In this example, even if Madoff and his audit firm did not submit the auditor's name to the database, then one of the investors surely would have. And, by having Madoff's auditor's name submitted, a

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cross check would have been performed. This cross check with the AICPA's records would have revealed that Madoff's audit firm claimed to do no audits, when it did do at least one (Madoff's). An investigation following this revelation might have uncovered that the audits were not performed professionally. At the very least, Madoff's audit firm would have undergone the peer review process.

Bernie Madoff was less than truthful when saying that he did not have an investment advisory business. Later on, he said he did act as investment advisor, but claimed to have fewer than 15 investors and thus did not need to register with the SEC. In 2006, the SEC finally discovered that Madoff did have more than 15 clients. At that time, the SEC merely required Madoff to register with the SEC and all was forgiven. To discover such a fraud sooner, the authors recommend that investors (individuals and feeder funds) who invest more than \$250,000 with an investment advisor be required to report the name of their investment advisor to the SEC. Again, a database would be created and cross checked. If this requirement had been implemented, Madoff would have been discovered to have had a large investment advisory business many years ago. That business would have, presumably, been audited by the SEC, just as the market maker business was.

The feeder funds who funneled monies into Madoff claimed to have conducted due diligence but many conducted little, if any, due diligence. It is this shoddy lack of due diligence that enabled, in part, the Madoff Ponzi scheme to continue for as long as it did. The authors recommend that feeder funds be required to conduct specific due diligence steps. Further, the funds will be required to document that they performed

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such steps and retain such documentation for seven years. The feeder funds will be required to repeat the due diligence steps on an annual basis.

As a minimum requirement, the required due diligence must include verification of specific trades and account data with independent third parties. In addition to this specific step, feeder funds should be required to look at the big picture as well. In the Madoff example, as noted above, the strategy and volume Madoff claimed to be doing would have equaled 82% of the entire market for options. This big picture claim is readily verifiable by experts in options trading. No check was made with options trading experts by some feeder funds prior to investing with Madoff. Had they done so, they would have realized that none of the options traders had ever heard of Madoff. The SEC will audit the feeder funds' documentation, per the authors' recommendation.

In Madoff's scheme, he claimed to hold all of the securities and his firm issued all of the investors' statements. Any investment advisor should be required to have an independent third party maintain custody of any invested assets. Further, the third party should be the only entity that provides net asset value statements to the investors.

Firms that audit investment advisors and broker-dealers, whether their clients are public or private, should undergo a more rigorous peer review process to ensure to a reasonable level of satisfaction that the audit firm has the ability, expertise, competence and resources to conduct audits of such complex entities. Rather than a voluntary peer review process required by a professional organization, the peer review should be required by the SEC and possibly administered by the SEC as well.

The authors recommend that the SEC establish a whistle blower program. Such a program will be designed to allow individuals who believe they have discovered fraud

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in a hedge fund or some type of a Ponzi scheme the freedom and anonymity to report their suspicions without fear of reprisal. The whistle blower program would serve as a vehicle through which to submit evidence of such fraud. The SEC will be required to review and reply to every complainant.

The whistle blower would enjoy protection and severe criminal and financial penalties will be established if there is any retribution against the whistleblower. This recommendation of protection for whistle blower's is similar to the protection enjoyed by employees of publicly traded companies as defined in Section 806 of Sarbanes Oxley.
"SEC. 806. PROTECTION FOR EMPLOYEES OF PUBLICLY TRADED COMPANIES WHO PROVIDE EVIDENCE OF FRAUD. (a) WHISTLEBLOWER PROTECTION FOR EMPLOYEES OF PUBLICLY TRADED COMPANIES- No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--" (Section 806, Sarbanes Oxley, www.SOXonline.com).

A long-term recommendation is to require feeder funds, broker-dealers, and other investment intermediaries to establish a hiring and training program that tests for and seeks to hire ethical employees. Further, this program would train personnel to spot fraud, and how to report it. With a greater emphasis on ethics and fraud, it is believed a scheme may be prevented, or at least detected at an earlier stage.

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The authors recommend that business schools increase their emphasis on ethics and integrity with their students, as well as emphasize the consequences of falling short. While one may not be able to change human nature, it is important that business schools establish higher standards and expectations of its students, to be maintained beyond graduation. The authors acknowledge that business schools have increased their ethics education efforts. Unethical behavior by business leaders hurts the entire field of business, including academe. Therefore, more can and should be done.

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As noted earlier, one reason many experts did not discover the fraud is that they were getting paid handsomely in fees to bring new investors to Madoff. These persons who likely should have known better had a huge financial disincentive to do extensive due diligence. The authors recommend consideration of regulating the fee structure that such feeder funds receive or at a minimum, disclosure of the fee structure to investors.

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The SEC's hiring practices and policies should be addressed. The SEC should seek to hire street smart experts who truly understand the financial institutions and markets. Some suggest the SEC hires primarily lawyers straight out of law school, who do not understand the inner workings of the financial systems. Thus, they are less able to discern when something is amiss. Further, some SEC employees leave the SEC after a few years and go to work immediately for the Wall Street firms they are charged with regulating. It is reasonable to ask how vigorously the SEC employees will investigate their potential future employer. The authors recommend that SEC employees be prohibited from accepting a job with any firm that falls under SEC regulation for a period of one year. This recommendation is consistent with the time period included in SEC. 206 of Sarbanes Oxley.

CONFLICTS OF INTEREST- It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit (www.SOXonline.com).

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This regulation permits employees from audit firms to work for their client, but it prohibits that firm from auditing the client for a period of one-year.

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Perhaps another example is in order. This example comes from politics and government. The 2007 Honest Leadership and Open Government Act (HLOGA) prohibits former congressman and senators, as well as certain other former members of the federal government from lobbying for a period of one year. Note: Former senior administration officials face stricter requirements (www.capdale.com).

An investor education program should be established. Such a program should include not only the basics of a Ponzi scheme, as enumerated herein, but also practical ways individual investors might perform a reasonable level of due diligence, as well as suggest a list of questions to ask its investment advisor. This investor education program should be required of all investors, including qualified purchasers, sophisticated purchasers, and accredited investors.

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~~For example, Madoff's audit firm was able to circumvent the AICPA's requirement that firms which perform audits be peer reviewed, simply by lying and claiming that it did not perform any audits. A potential way such a fraud could be discovered is by requiring that audits their entity that audits.~~

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~~Further, a shared database of audit firms should be created. This database would be designed to automatically cross check the data for discrepancies. Further, in addition to the automatic cross checking performed by the computer, the database could be audited by experts. For example, had this database existed, then the name of Madoff's audit firm would have been submitted to the database, if not by Madoff, if not by the audit firm, then by an investor or potential investor in Madoff. Note: "investor" could be an individual, a feeder fund, or a fund of funds in this example. By having Madoff's auditor's name submitted, a cross check would have been performed. The discovery that the firm claimed to do no audits, when it did do at least one, would have been discovered. An investigation could have uncovered that the audits were not performed professionally. At the very least, the firm would have had to undergone the peer review process. The feeder funds claimed to have conducted due diligence but many did not. A potential solution is to The SEC could then audit the feeder funds' documentation. (or some other agency or entity could perform due diligence audits)~~

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~~———— Madoff held all of the securities and issued all of the statements. Investors should insist that any fund it invest in that The assets should be administered independently as well. Due diligence would further require that it the audit firm~~

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~~—The SEC should establish a whistle blower program to allow individuals who believe they have discovered a hedge fund or Ponzi fraud freedom and anonymity and a vehicle through which to submit evidence of such fraud.~~

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~~—Long term recommendations include a hiring and training program that tests for and seeks to hire ethical employees. (this is sticky.) Additional requirements would be to recommend that business schools increase their emphasis on ethics and integrity, and the consequences of falling short.~~

~~A reason many experts did not discover the fraud is that they were getting paid handsomely in fees to bring new investors to Madoff. These persons who likely should have known better had a huge financial disincentive to do extensive due diligence. Perhaps the fee structure should be regulated to be less lucrative. (I hate this suggestion.)~~

~~—Bernie lied and said he did not have an investment advisory business, then he said he had fewer than 15 investors. Solution: Require investors who invest more than \$1 million with an investment advisor to report same to the SEC. Again, a database would be created and when cross checked, Madoff would have been discovered to have had an investment advisory business years ago. That businesses would have, presumably, been audited by the SEC, just as the market maker business was.~~

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~~—The SEC's hiring practices and policies should be addressed. The SEC should seek to hire street smart experts who truly understand the financial institutions and~~

~~markets. Some suggest the SEC hires primarily lawyers straight out of law school, who do not understand the inner workings of the financial systems. Thus, they are less able to discern when something is amiss. Further, some SEC employees leave the SEC after a few years and work for Wall Street firms. How vigorously are they going to investigate their potential future employer? The SEC should pass a law that prohibits its employees from taking a job with any firm that falls under SEC regulation for a period of xxxx.~~

~~An investor education program should be established. Such a program should include not only the basics of a Ponzi scheme, as enumerated herein, but also practical ways individual investor might perform a reasonable level of due diligence, or at least suggest a list of questions to ask its investment advisor.~~

CONCLUSION AND FUTURE RESEARCH

~~Madoff was able to continue his Ponzi scheme for many years by exploiting flaws in the regulatory system, but also by exploiting human nature. Yes, he was less than truthful with ~~lied to the SEC as was the~~ . ~~Yes, his audit firm lied for him as well.~~ Yes, feeder funds were paid handsomely to not ask too many questions, allegedly. Yes, the SEC was woefully deferential and lax when investigating this former chairman of NASDAQ. But Madoff also exploited investors' greed, and their desire for safe returns. Having said that, there is no excuse to not continue the approach of *-caveat emptor (let the buyer beware)* that was prevalent many years ago. After all, many investors invested their life savings in Madoff. Should they have not been more diligent and~~

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asked more questions when entrusting their financial security and their children's' and grandchildren's' inheritance?

Future research should further explore how the system was exploited in perpetrating, expanding, and continuing Madoff's this, and other Ponzi schemes. An evaluation of the SEC's Securities Act of 1933, Securities Exchange Act of 1934 and Investment Company Act of 1940 should be completed. Through this evaluation, suggestions can be made about how changes to the current legislation can help to protect future investors from becoming victims of future Ponzi schemes.

In addition to reviewing current legislation and offering suggested changes to that legislation, future research could consider additional regulations to be implemented by the SEC. These regulations would be put in place to safeguard future investors considering investing in hedge funds.

Future research should look into the hiring practices of the SEC. It should consider the actions of its employees and the trends (if any) of employees taking lucrative positions in the same firms that they were charged with regulating. The research should consider if the SEC should institute a non-compete clause into their employee contracts, hopefully limiting the effects of the SEC employees ignoring actions of the firms they are regulating and/or investigating. Also, considering the effects of non-compete clauses in the investment markets and how this could then be extended to and implemented by the SEC.

Future research should consider the SEC's policy on how they deal with receiving tips on possible fraud. It should consider the current policy of the SEC on

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dealing with tips, how effective the process is in terms of action taken on the tips, and what percentage of tips are accurate. Suggestions should be offered on a formal policy for tips and whistle-blowers, including incentives for tipsters and whistle-blowers to take action without fear of reprisal.

Future research should consider the incestuous relationship between the Securities and Exchange Commission and Bernard Madoff's investment advisory firm. The research should look into the role of special treatment offered high-powered executives dealing with investments. Specifically, is there a relationship between the SEC and these high-powered current and past executives that allows for special treatment under the SEC? If there is special treatment, what are the implications for the general public and how should legislators then react to this issue?

Future research should consider the models of investor education curriculum, if any exist. Various forms of curriculum should be reviewed and considered, direction should be formulated in terms of desired curriculum outcome, and target audience for each curriculum should be determined. Also, there should be consideration of ethical standards within the investment markets and perhaps a requirement put into place with regards to ethics certification for all investment advisors on a regular basis.

Future research must undoubtedly focus on more stringent regulations to protect investors from unscrupulous fraudsters such as Bernard Madoff. However, even when rules and regulations are in place, there will be someone waiting in the wings to take exception to the intent of the rules. As one former Enron employee stated:

Say you have a dog, but you need to create a duck on the financial statements. Fortunately, there are specific accounting rules for what

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constitutes a duck: yellow feet, white covering, and orange beak.
So you take the dog and paint its feet yellow and its fur white and
you paste an orange plastic beak on its nose, and then you say to
your accountants, 'This is a duck! Don't you agree that it's a duck?' And
the accountants say, 'Yes, according to the rules, this is a duck.'
Everybody knows that it's a dog, not a duck, but that doesn't matter
because you've met the rules for calling it a duck (Satava, Caldwell
& Richards, 2006).Future research should recommend additional policies,
strategies, safeguards, and common sense solutions to prevent and detect such
schemes.

Future research should consider the role of the SEC in preventing and detecting fraud.
It should look at the SEC's hiring practices, the actions of its employees, the trend, if
any, of employees taking lucrative jobs in the same firms that they are charged with
regulating, and its vetting process when it receives tips on possible fraud.

Future research should focus on what some claim is an incestuous relationship between
the Sec and Madoff.

Future research should examine or create optimal models of investor education
curriculum and test such curriculum with potential and actual investors.

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Recommendations:

Require all investment advisors, broker dealers, feeder funds, etc. to send the name of their audit firm, and the name of the audit firm of the money managers they invest in, to PCABO and the SEC and AICPA for cross checking. Perhaps doing so would prevent the ability to avoid the peer review process by audit firms.

Require feeder funds (of a certain size) conduct specific due diligence steps, and document that they performed such steps:

- Ensure an independent third party maintains custody of any invested assets and provides net asset value statements to all investors.
- Investigate the audit firm and ensure to reasonable satisfaction that it has the ability, competence and resources to conduct audits of hedge funds.

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