

Before and After Bernie: Ponzi Regulation or Lack Thereof?

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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, 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, the Securities and Exchange Commission, as well as the investors themselves. This paper reviews the history of Ponzi schemes, the role of auditors in perpetrating these schemes, and the role of the SEC. In conclusion, this paper will suggest changes to regulation and procedure so that investor faith and confidence will be restored.

Field of Research: Accounting

1. 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 and how to prevent future schemes from occurring. Since the Madoff scheme became public, many other schemes have come to light and the media has been playing a blame game ever since, focusing on the accounting profession, the Securities and Exchange Commission and the investors themselves. This paper will review what a Ponzi scheme is, the history of Ponzi schemes, the role of auditors in perpetrating these schemes, and the role of the SEC. In conclusion, this paper will suggest changes to regulation and procedures so that investor faith and confidence will be restored.

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2. The History and Background of Ponzi Schemes

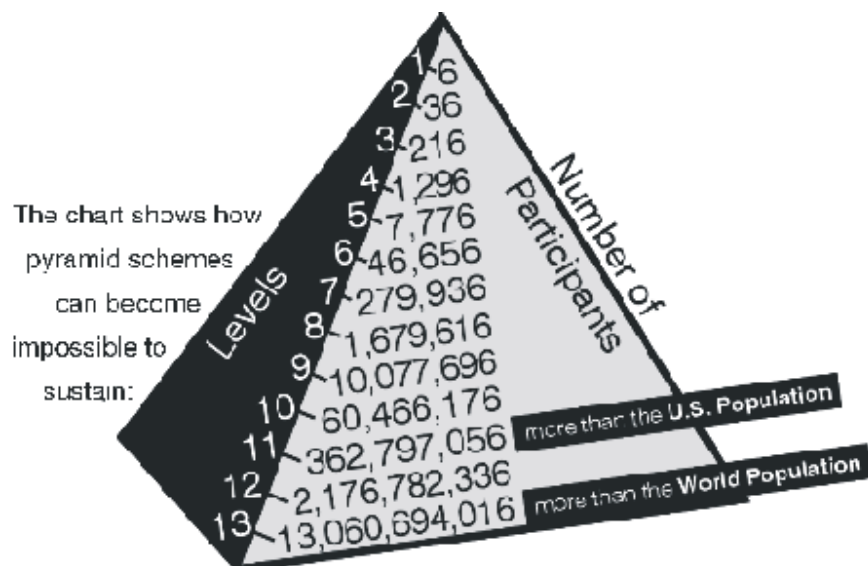
Long before Bernie Madoff, men and women have defrauded the general public as well as sophisticated investors with the use of Ponzi schemes. Some fraudsters had flashy names, such as William "520 percent" Miller and RaeJean "Rapmaster 20K Percent" Bonham. Others used sophisticated or official sounding 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.

Ponzi schemes 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). 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. As the chart above demonstrates, if each new member needs to recruit just six 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 people than exist on the planet. Again, an obvious flaw in the sustainability of the Pyramid scheme. Whether recruiting new members (Pyramid) or new monies (Ponzi) the results are the same. The fraud is simply not sustainable over the long term.

3. Who was Charles Ponzi?

Carlo "Charles" Ponzi was an Italian who, at the age of 21, emigrated to Boston in 1903. 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 the United Postal Union (UPU) which was established in 1874 to aide cooperation between postal-sector players (Universal Postal Union, 2001). Ponzi calculated that coupons purchased in Italy were worth six times as much in the US as a result of 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 (Clikeman, 2009). Ponzi's scheme collapsed when investors demanded their funds after word got out. Ponzi 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 (2008, A century of Ponzi schemes).

In modern times, fraudsters have perpetrated 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.

4. Regulation or Lack Thereof

4.1 The Security and Exchange Commission

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 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, which is 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.

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

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 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

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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 Madoff's case the rules were violated. 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" (Norris, 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 (Sarbanes-Oxley Act, 2002). 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).

4.2 Auditors and the Accounting Profession

Technically, 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 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 yacht). There is no record of even a single trade having been made on behalf of his investors.

Friehling & Horowitz is a three-person accounting firm that is operated out of a 550 square foot office in Rockland County, New York (Bloomberg News, 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 Friehling & 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

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(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 Friehling and Horowitz 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, 2009b, Rule 101, Section 101.01). 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, 2009b, Rule 101, Section 101.02, Interpretation of Rule 101).

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, 2009). 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, 2009a). 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, 2009a). 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" (Dugan & Crawford, 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.

5. 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-

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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).

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.

6. Recommendations

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

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. 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 cross check would have been performed. This cross check with the AICPA's records would have revealed that Madoff's audit firm was falsely claiming that it performed no audits.

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.

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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 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 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.

7. Conclusion and Future Research

Future research should further explore how the system was exploited in perpetrating, expanding, and continuing Madoff's, 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 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 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.

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