Conducting Effective Ponzi Scheme Investigations

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For 40-plus years, Bernard L. Madoff was well respected within the Jewish and investment communities. In 1960, he launched his Wall Street firm, Bernard L. Madoff Investment Securities (BMIS), and served as its Chairman until 2008. In the early 1990s, he served for three years as Chairman of the NASDAQ stock market. In addition, Mr. Madoff was invited to serve on a government advisory panel on stock market regulations, served on numerous charitable organization boards, and started a family foundation. Year after year Mr. Madoff’s investment firm reported annual returns of 10% to 12%, even in down markets. Such amazingly consistent returns created a frenzy of demand to invest with his firm, which on paper was valued at $65 billion (Oppenheimer 2009). However, on December 10, 2008, Mr. Madoff confessed to his two sons that his exclusive investment fund was “all just one big lie” and was “basically, a giant Ponzi scheme” (United States of America v. Bernard L. Madoff 2008). On March 10, 2009 Mr. Madoff pled guilty to 11 criminal counts including securities fraud, mail fraud, wire fraud, investor advisor fraud, money laundering, false statements, perjury, false filings with the SEC, and theft from an employee benefit plan (United States of America v. Bernard L. Madoff March 2009). On June 29, 2009, Mr. Madoff was sentenced to 150 years, which he is currently serving at a medium-security federal prison in North Carolina (United States of America v. Bernard L. Madoff June 2009). Ultimately, Mr. Madoff had bilked investors out of billions of dollars using one of the oldest and simplest fraud tricks of the modern era: the Ponzi scheme.

After the 17-year time span encompassed by Madoff’s Ponzi scheme and the resulting billions in investors’ losses, the Chairman of the Securities and Exchange Commission (SEC) directed the SEC Office of Inspector General (OIG) to investigate the SEC’s failure to uncover Madoff’s Ponzi scheme. The Report of Investigation dated August 31, 2009 concluded that “despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed. The OIG found that between June 1992 and

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December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff’s hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading” (OIG 2009, 21). The SEC investigators responsible for following up on the six substantive complaints did not have a sufficient understanding of the following three issues critical to effectively investigating Ponzi schemes:

1. Understanding what a Ponzi scheme is and how it works;
2. Detecting the red flags of a Ponzi scheme; and
3. Conducting an effective Ponzi scheme investigation.

It is impossible to effectively investigate a Ponzi scheme—or any other fraud scheme—without first developing a thorough understanding of each of the above three issues. Accordingly, this paper explores in detail each of these issues in order to enhance the effectiveness of future Ponzi scheme investigations.

**UNDERSTANDING PONZI SCHEMES**

A Ponzi scheme is a fraudulent investment “opportunity” in which current investors are paid too-good-to-be-true returns out of the money paid in by newly-recruited investors, rather than from the profits generated by any legitimate business activity. The scheme is dubiously named after Charles Ponzi, an Italian immigrant who bilked almost 40,000 investors out of $20 million dollars in 1919 – 1920 (Wells 2009). Ponzi promised investors he could double their investment in 90 days by using the investors’ funds to purchase international postal reply coupons. During that period, many European countries had experienced severe currency devaluations in the aftermath of World War I. Ponzi claimed he could buy the international postal reply coupons in bulk in the weaker European currencies, and then redeem them for U.S. postage stamps, which could then be converted into the much stronger American dollar at a substantial profit. He did not clearly explain how the postage stamps could be converted in dollars but did state, “A little dollar could start on a journey across the ocean and return home in six weeks, married and with a couple of kids” (Margolick 2005). Although Ponzi did pay a high return to the early investors (and to himself), this money came from new investors and did not come from profits allegedly generated by the postage stamp conversion business. When the fraud was eventually exposed eight months after it began, Ponzi possessed all of approximately $30 in postal reply coupons (Wells 2000).
How Ponzi Schemes Work

The typical Ponzi scheme works as follows: the investment promoter promises or even guarantees an extraordinary return on an investment, such as 10% per month. The source of such extraordinary returns is typically attributed to something that sounds impressive but is intentionally vague, such as hedge fund futures trading, global currency arbitrage, high yield investment programs, or, as in Mr. Madoff’s case, the split strike conversion strategy. If pressed by skeptical investors for more detail, the promoters typically evade answering the question and instead talk about how recently-recruited investors have been receiving the promised returns. Since the investment opportunity has no track record, early investors typically invest relatively small amounts such as $10,000 and wait to see if the promised returns are paid. After one month the investor receives a check for $1,000, so the investor truly believes s/he has earned the promised return. What the investor doesn’t realize is that the $1,000 was a return of the investment and not a return on the investment. In other words, the $1,000 return came from the $10,000 principal initially invested or from a newly-recruited investor, rather than from any profits generated by the investment opportunity. After a second month yields another $1,000 payment, the investor is ‘hooked’ and typically will invest larger amounts in the scheme and will enthusiastically inform friends and family members about this ‘fantastic’ investment opportunity. Since these early investors have actually received the promised returns, their promotion of the investment comes across as genuine and instills an almost irresistible urge in friends and family members to invest as well.

Escalation

Since the early investors have become effective marketing tools, the investment founder no longer needs to promote the investment. At this point, the cash really begins flowing in and the investment promoter’s lifestyle typically escalates to the level of extravagant. Ostentatious houses, luxury cars, designer clothes, and exotic vacations all contribute to the illusion that the investment promoters are successful business people. Some examples of the Madoffs extravagant lifestyle include: a French chateau valued at $1 million, with furnishings worth an estimated $900,000; an 8,753-square-foot, five-bedroom mansion in Palm Beach, Florida purchased for $3.8 million; two boats – a classic 1969 Rybovich motor yacht that cost $2.2 million and an ultra luxurious $7 million ocean-going yacht; and purchases totalling $137,171.01 on Madoff’s July 2008 American Express bill, which was paid immediately (Oppenheimer, 2009).
Rather than view the promoter’s extravagant lifestyle as a red flag, investors tend to view them as possibilities for themselves in the not-so-distant future. In other words, greed overwhelms reason and logic. Another aspect of Ponzi schemes that allows them to continue for an extended time is that the investment promoters do not have to pay out much money since those receiving the promised returns tend to reinvest their money into it. Thus, the promoters must simply send paper statements to investors showing how much they have allegedly earned on their investment, which is typically much higher than any alternative investments available to them.

**Affinity Fraud**

To obtain or maintain the confidence of prospective or current investors, Ponzi scheme investment promoters often exploit the trust and friendship that exists in groups of people that share a common demographic characteristic. Such “affinity frauds” typically target religious or ethnic communities, the elderly, or professional groups. Some victims of Mr. Madoff, who is Jewish, included Yeshiva University, Hadassah, the American Jewish Congress, and the foundation of Noble Peace Prize winner and Holocaust survivor Elie Wiesel, among other prominent Jewish organizations and charities (Greenberg 2009). Because of Mr. Madoff’s Jewish background, many of his victims simply trusted him without conducting the due diligence or asking the tough questions they otherwise would have asked prior to investing large amounts of money.

**Types of Ponzi schemes**

There are two types of Ponzi schemes: those that are frauds from the beginning, and those that evolve into frauds over time. Charles Ponzi’s scheme was of the first type. After conducting an investigation, the chief post office inspector concluded that “Ponzi had never done any business in international reply coupons….Ponzi’s claim that he has made millions in this way is simply a stupendous fraud” (*New York Times* 1920). Thus, Ponzi’s scheme was a fraud from the beginning, as he never did purchase significant quantities of postal reply coupons.

In contrast, Madoff’s scheme started out legitimate and evolved into a fraud over time. BMIS consisted of both a stock trading operation, which was legitimate, and an investment advisory business, which was where the Ponzi scheme evolved. According to Irving Picard, the court-appointed trustee responsible for liquidating BMIS, “there was no evidence that Mr. Madoff bought any securities for clients in at least 13 years” (Dugan 2009). Since the investment advisory business existed for 17 years, it apparently did purchase securities for the first few
years. Harry Markopolos, the Certified Fraud Examiner (CFE) and Charter Financial Analyst (CFA) whose warnings were repeatedly ignored by the SEC investigators, tried to replicate Madoff’s amazingly consistent annual returns of 10% to 15% by examining OEX Standard & Poor’s 100 Index Option volume statistics from the Chicago Board Options Exchange. In testimony before the U.S. House of Representatives Committee on Financial Services, Markopolos asserted that “there were not enough OEX options in existence for [Madoff] to be managing the split strike conversion strategy he purported to be running….I was incredulous as to how any[one] would willingly invest in such an obvious fraud” (Markopolos 2009, 10).

**Inevitable Collapse**

The structure of the Ponzi scheme inevitably dooms it to failure over time because it is mathematically impossible to sustain. Since little, if any, of the victims’ funds are actually invested into a legitimate profit-generating activity, the scheme can continue for only as long as the cash inflows from new and existing investors exceed the cash outflows to existing investors. However, as the number of investors grows rapidly, the pool of new investors unavoidably shrinks. At some point, the cash flow situation collapses resulting in one of four possible outcomes: (1) the investment promoters disappear, taking any remaining investment money with them; (2) the scheme collapses of its own weight, as investor recruiting slows and the promoters have problems paying out the promised returns and, as the word spreads, more people start asking for their money creating a run-on-the-bank situation; (3) the scheme is exposed when regulators examine the accounting records of the business and discover that the majority of the listed assets do not exist; and/or (4) the investment promoters turn themselves in and confess.

According to the criminal complaint filed on December 11, 2008 in the Southern District of New York, Mr. Madoff confessed to federal investigators that there had been requests from clients for approximately $7 billion in redemptions yet he only had approximately $200 - $300 million left (United States of America v. Bernard L. Madoff 2008). Accordingly, his cash outflows to satisfy redemption requests exceeded available cash on hand by more than $6 billion. Consequently, Madoff had to either flee the country or turn himself in and confess, which is what Mr. Madoff chose to do.

**Prevalence of Ponzi Schemes**

According to the Associated Press’ examination of criminal and civil cases at both the federal and state levels, more than 150 Ponzi schemes collapsed in 2009, compared to about 40
in 2008 (Anderson 2009). It is not a coincidence that Madoff’s Ponzi scheme was exposed during the 2007 - 2009 U.S. economic recession. During economic downturns, the cash inflows from new investors predictably decrease and cash outflows to satisfy redemption requests increase, as investors face increasing financial pressure. However, it is unusual that Madoff’s Ponzi scheme continued for 17 years, and even survived the economic recession of 2001. According to the court-appointed trustee, Madoff’s Ponzi scheme encompassed thousands of investors, who collectively lost an estimated $21 billion (Henriques 2010). Had the SEC investigators better understood Ponzi schemes, they would have uncovered Madoff’s scheme in 1992 when the first complaint was brought to their attention, which would have saved thousands of investors billions of dollars in losses.

In the end, the investment promoters—if they can be apprehended—go to jail and the investors lose most or all of their money. In retrospect, most investors berate themselves for being so greedy and gullible. Unfortunately, many investors are wiped out financially and never fully recover. Most, if not all, of these tragedies could have been avoided had the SEC investigators been properly educated about detecting and investigating Ponzi schemes.

DETECTING PONZI SCHEMES

The first step in detecting Ponzi schemes is to develop a thorough understanding of the suspect organization and the environment in which it operates. In addition, “the performance of the overall economy and its effect on the industry and organization should be undertaken” (Kranacher, Riley, & Wells 2011, 182). Clarence Barron, a financial analyst who exposed Charles Ponzi’s fraud, understood Ponzi’s postal reply coupon investment strategy well enough to know that, in theory, there was profit to be made off the currency exchange rates. However, in an article exposing Ponzi’s scheme published in the Boston Post in July 1920, Barron argued that Ponzi could never make more than a few thousand dollars exchanging the coupons, not because of the labor-intensive nature of selling the stamps and executing the required currency exchanges, but because there simply weren’t enough coupons in circulation (Wells 2000). Ponzi’s scheme began unraveling soon thereafter.

For nine years, Harry Markopolos, a CFE and financial derivatives expert, submitted several written reports and e-mails to the SEC’s Regional Directors of Enforcement (DOE) explaining that BMIS could not be generating its reported returns using the split strike conversion strategy as claimed by Madoff. Markopolos even met with at least two DOEs to explain to them, in person and using a white board, how a split strike conversion strategy works
and how Madoff’s return stream did not resemble any known financial instrument or strategy. Regarding one of these meetings Markopolos recalled, “I was shocked by his financial illiteracy and inability to understand any of the concepts presented.” From his unsuccessful meetings with the SEC Markopolos came to understand “that financial illiteracy among the SEC’s securities lawyers was pretty much universal” (Markopolos 2005, 11). Accordingly, it is not surprising that the SEC did not detect a scheme that they did not or could not understand due to a lack of experience, credentials, and/or education.

The second step in detecting Ponzi schemes is knowing and recognizing the red flags typically associated with them. In his submission to the SEC dated November 7, 2005, Markopolos listed and explained in substantive detail 29 red flags that Madoff was perpetrating a Ponzi scheme. Markopolos concluded that the existence of the 29 red flags “lead to a weight of the evidence conclusion that this is a Ponzi scheme” (Markopolos 2005, 9). The presence of a single or even multiple red flags does not necessarily indicate a fraud and would not be sufficient to prove a fraud in court. However, such red flags do provide sufficient predication – defined as “the totality of circumstances that lead a reasonable, professionally trained, and prudent individual to believe that a fraud has occurred, is occurring, and/or will occur” (Kranacher, Riley, & Wells 2011, 32) – for launching a fraud investigation. By failing to conduct a competent investigation of BMIS, the SEC breached a fiduciary duty of care it owed to those invested in Madoff’s Ponzi scheme. At least one lawsuit has been filed against the SEC by former Madoff investors alleging the “gross negligence of the United States Securities and Exchange Commission (SEC) in performing its multiple investigations and examinations of Bernard Madoff and his firm…. [T]he SEC had countless opportunities to stop the Ponzi scheme Madoff operated over 16 years and botched all of them” (Molchatsky and Schneider vs. United States of America 2009, 1 – 2).

**Ponzi Scheme Red Flags**

Many of the red flags typically associated with Ponzi schemes can be derived from a thorough understanding of how the scheme works. Accordingly, some of the more common red flags include:

**The promise or guarantee of returns exceeding normal market returns.** Charles Ponzi promised investors that they could double their investment in 90 days, which was a 400% annual return at a time when banks were paying 2% (Wells 2000). Madoff promised investors he could return 8% to 12% per year, regardless of how the overall markets performed. Over his 17-year
track record, Madoff reported “an impressive total return of 557%, with no down year and almost no negative months” (Gregoriou and Lhabitant 2009, 8). As noted by Harry Markopolos, Madoff reported positive returns for more than 96 percent of the months he reported on “which would be akin to a Major League Baseball player batting .960” (Jackson 2010, 45). Most Ponzi schemes collapse much sooner than the 17 years it took for Madoff’s scheme to come to light. This was, in part, due to the fact that Madoff’s promised returns, which exceeded normal market returns, were not as completely outrageous as returns promised by other Ponzi schemes. A slight modification of an old adage is especially true today: If an investment seems too good to be true, it probably is a Ponzi scheme.

*Complicated and secretive trading strategies.* The source of the extraordinary returns is typically attributed to something that sounds impressive but is intentionally vague or complicated, such as hedge fund futures trading, global currency arbitrage, high yield investment programs, or, as in Mr. Madoff’s case, the split strike conversion strategy. If pressed by skeptical investors for more detail, the promoters offer cryptic explanations such as “I can’t explain it to you in detail because then I’d be giving away my secrets.” In Madoff’s case, a *Barron’s* article as early as 2001 questioned how he was able to generate such impressive returns. “Madoff’s investors rave about his performance – even though they don’t understand how he does it” (Arvedlund 2001, 1). The article quoted a “very satisfied investor” as admitting, “Even knowledgeable people can’t really tell you what he’s doing” as well as a strategist at a major investment bank and investing firm, who had been asked to run some numbers on behalf of a client who was thinking of investing with Madoff, as saying, “I’ve been replicating this strategy six ways to Sunday and I can’t make the returns come out right” (Arvedlund 2001, 1). In November 2008, Richard Gordon, a member of the investment committee for the American Jewish Congress, asked how Madoff could be making money in one of the worst markets in history. “I could explain it to you, Richard, but it’s too complicated,” Madoff replied (Bandler and Varchaver 2009, 12). When pressed by a financial reporter to explain his investment strategy, Madoff responded with nonsensical financial jargon: “The basic strategy was to be long a broad-based portfolio of S&P securities and hedged with derivatives” (Kirtzman 2009, 66). Following one of Warren Buffet’s basic rules of investing is very effective in avoiding Ponzi schemes: if you don’t understand a company’s product or how it makes money, avoid it (Brush 2009). The inability to replicate, explain, or understand an investment strategy should be construed as a huge red flag.
**Exclusive nature of the investment.** Madoff’s promise to investors was quite appealing: modest but reliable returns regardless of market volatility. Madoff himself determined who would be admitted into his private, exclusive investment club for the wealthy. For years, the minimum cost of admission was $5 million, and investors could be expelled if they told anyone about investing with him. Adding to Madoff’s air of mystery was his elusiveness to individual investors. Madoff rarely appeared at social events, infrequently met with his own sales agents, and was inaccessible to bankers interested in helping prospective investors. “You couldn’t meet Madoff. He was like a pop star,” declared one banker who was considering offering loans to customers so they could invest with Madoff (Frank and Lauricella 2008, A1). The perception of exclusivity created an irrational frenzy of demand wherein prospective investors “begged their friends who were Madoff insiders to get them in” (Oppenheimer 2009, 3). Such exclusivity and irrational demand are typical of Ponzi schemes.

**Inadequate segregation of functions and/or nepotism.** The typical hedge fund includes an investment manager, a broker to execute trades, a fund administrator, and a prime broker to custody the positions. Ideally, these four service providers should be independent of each other and their functions properly segregated. In Madoff’s case, all of the above-mentioned functions were performed internally, mostly by close family members (Fuerman 2009). Mr. Madoff’s brother, Peter, was senior managing director, head of trading, and chief compliance officer. Madoff’s nephew, Charles Wiener, was the director of administration. Madoff’s oldest son, Mark, was director of listed trading. Madoff’s youngest son, Andrew, was director of NASDAQ trading. Madoff’s niece, Shana, served as the in-house legal counsel and rules compliance attorney. Consequently, all assets were managed within Madoff’s organization, which also produced the documents ‘verifying’ the existence of the underlying investments. Consequently, Madoff’s investors had no choice but to blindly rely on Madoff himself, or on his auditor, to verify the existence and accuracy of the trading information (Gregoriou and Lhabitant 2009, 10). Such inadequate segregation of functions and heavy reliance on family members should be construed as major red flags and create easy-to-exploit opportunities for financial mischief.

**Obscure, non-independent auditor.** From 1991-2008, BMIS was audited by a three-employee local accounting firm called Friehling and Horowitz, which had a tiny office in suburban New City, New York (Fuerman 2009). In contrast, Madoff feeder funds were audited by large and reputable international accounting firms such as PricewaterhouseCoopers, KPMG, BDO Seidman, or McGladrey & Pullen. How can a $65 billion investment fund be effectively audited
by such a small accounting firm? It can’t! An effective audit of a $65 billion dollar investment fund would require a small army of auditors. Not surprisingly, David Friehling confessed to prosecutors that he issued an unqualified opinion on BMIS’s financial statements without conducting any independent verification of Madoff’s business revenue, assets or stock-trading claims (McCoy 2009). In addition, the SEC has brought another action against Mr. Friehling alleging that his accounting independence was impaired since he had more than $14 million invested with Madoff. Clearly, Friehling’s inadequate firm size and his lack of independence should have been viewed as major red flags.

Miscellaneous anomalies. An anomaly is anything that is different from what would normally be expected or defies common business sense. All fraud schemes, including Ponzi schemes, generate anomalies. The ability to recognize anomalies is predicated upon a comprehensive understanding of the business and the environment in which it operates. Some obvious anomalies present in the Madoff case include:

- **Lack of staff.** In its regulatory filing with the SEC, BMIS “indicated that it had between one and five employees who performed investment advisory functions, including research. Simultaneously, it disclosed $17 billion of assets under management” (Gregoriou and Lhabitant 2009, 12). How could a $17 billion investment fund be effectively managed by so few people? Clearly, it defies common business sense.

- **No electronic access to accounts.** While most brokers provide their clients with electronic access to their accounts, Madoff did not. Madoff clients could only receive paper tickets by mail at the end of the day. “On some occasions, the paper tickets had no time stamps, so the exact order of the purported transaction was unclear” (Gregoriou and Lhabitant 2009, 12). Such a practice was necessary for Madoff to be able to fabricate *ex post facto* trade tickets that confirmed investment results.

- **SEC registration.** Madoff did not register as an investment advisor with the SEC until September 2006. One would normally expect that the manager of a multi-billion dollar investment fund would be registered as an investment advisor with the SEC. Madoff avoided registration by exploiting a regulatory loophole that exempted investment advisors with fewer than 15 clients. Prior to 2006, Madoff was allowed to count each feeder fund as one client. However, in 2006, the SEC changed the rule to require each client in the feeder fund to be counted as one client (Gregoriou and Lhabitant 2009, 12). Consequently, Madoff was then forced to register as an investment advisor.
In summary, to detect Ponzi schemes one must first thoroughly understand the organization’s business strategy and the environment in which it operates, and must also recognize the red flags typically associated with Ponzi schemes.

**INVESTIGATING PONZI SCHEMES**

Once a Ponzi scheme, or any fraud scheme, has been detected, it must be effectively investigated. Although the specific procedures employed to investigate a suspected fraud vary depending upon the nature and extent of the fraud, each investigation typically progresses through the following three sequential stages (Sharma, Sherrod, Corgel and Kuzma 2009, 10):

1. **Planning and Organization**
2. **Investigation and Evidence Gathering**
3. **Recommendation and Reporting**

**Planning and Organization**

When planning an investigation, the following six investigation questions need to be answered:

1. **Who is potentially involved in the suspected fraud or who else, although not involved, may have knowledge of the fraud?**

   Most frauds are known to others not involved in the fraud and most frauds are detected after receiving a tip from an informant who has knowledge of the fraud. In Madoff’s case, Harry Markopolos was the informant who, from 2000 – 2008, unsuccessfully attempted to persuade the SEC on dozens of occasions that “Madoff securities is the world’s largest Ponzi scheme” (Markopolos 2005, 2). According to Markopolos, other derivatives trading experts also knew that Madoff was a fraud but were unwilling to report it because of “undue career risk” (Markopolos 2005, 1). The informant providing the tip should generally be interviewed first and asked: (a) “How do you know this information?” and, (b) “What evidence do you have to support your allegations?” All of those potentially involved in or with knowledge of the fraud will eventually need to be interviewed in order, starting with those perceived to be least culpable and ending with those perceived to be most culpable for the suspected fraud.

2. **What is the potential magnitude of the suspected fraud?**

   A comprehensive fraud investigation costs money to conduct. Accordingly, an assessment of the potential magnitude of the fraud must be completed to justify the expected cost of the investigation. In Madoff’s case, the potential magnitude of the fraud
comprised billions of dollars and should have easily justified the costs of launching a comprehensive fraud investigation.

3. When was the suspected fraud committed?

Knowing the time frame the suspected fraud was committed is necessary to ensure that documents are requested for the appropriate time periods. In Madoff’s case, the fraud began shortly before the SEC’s 1992 investigation of Avellino & Bienes, which “became the first official Madoff feeder fund” (Oppenheimer 2009, 72). The fraud continued until Madoff’s confession to FBI agents on December 11, 2008. In general, the federal courts have long used a special rule for statutes of limitations in fraud cases, which usually is five years: “A victim of fraud has the full statutory time to file, beginning from the date the wrong came to light or would have with due diligence” (Rigney 2009).

4. Where was the suspected fraud committed?

The primary location where the fraud was committed is the ‘crime scene’ and is most likely where documentary, electronic, and other evidence can be found. Madoff’s Ponzi scheme was perpetrated on the 17th floor of the company’s headquarters in the Lipstick Building on the East Side of Manhattan and used an outdated IBM computer to fabricate investors’ statements (Oppenheimer 2009).

5. How was the suspected fraud committed?

Understanding how the fraud was committed is necessary to determine what documents to ask for, what questions to ask during interviews, and what other evidence will be required to prove the fraud. In Madoff’s case, he was taking money received from new or existing investors and using it to pay returns or redemptions to existing investors and to finance his and other family members’ extravagant lifestyles.

6. Why was the suspected fraud committed?

To prove fraud in court, evidence regarding the motive underlying the fraud must typically be presented. Although Madoff never divulged his motive in his confession to investigators, it appears that his motive was a combination of greed and pride. The greed grew from the Madoffs’ desire to live an ultra-extravagant lifestyle and socialize with the wealthy elite. The pride came from his inability to admit failure in his quest to provide investors with promised returns.

In addition to the six primary investigation questions, investigators should consider the following three secondary questions:
1. **Should outside legal counsel be retained?**

   The U.S. legal system adheres to the constitutional exclusionary doctrine of “If the constable blunders, the criminal goes free.” That is, if, during the investigation, investigators somehow violate a target’s constitutional rights or otherwise obtain evidence in a legally-inadmissible manner, the evidence obtained can be thrown out and the target may go free. Outside legal counsel can help investigators to successfully navigate these and numerous other legal pitfalls.

2. **Should consulting experts be retained, and, if so, in what capacity?**

   Investigators cannot be experts in everything. Effective investigators recognize the limits of their own expertise and will seek out those professionals with the relevant expertise to join the investigative team as consulting experts. In his testimony before Congress, Harry Markopolos berated the SEC investigators for their “investigative ineptitude and financial illiteracy” (Markopolos 2009, 4). Clearly, the absence of a relevant consulting expert on their investigative team greatly contributed to the SEC’s failure to uncover Madoff’s Ponzi scheme.

3. **What is the potential population of relevant documentation, both hard copy and electronic, that could provide information relevant to the suspected fraud?**

   Answering this question requires a comprehensive understanding of the suspected fraud scheme to determine the relevant documents and/or electronic evidence to request in resolving the fraud allegations. Madoff’s infamous split strike conversion strategy required the active trading of a specific basket of stocks, call options, and put options. Madoff claimed to implement this strategy over short-term horizons—usually less than a month—and allegedly the portfolio was in cash the rest of the time (Gregoriou and Lhabitant 2009). Accordingly, the key to uncovering Madoff’s Ponzi scheme was to request directly from the National Association of Securities Dealers (NASD) and the Depository Trust Company (DTC) documents verifying Madoff’s trading activities and cash positions, which had been non-existent for the last 13 years of the fraud.

Once the above questions are answered, a team of qualified professionals can be assembled to investigate the fraud by completing the subsequent steps described below.

**Information and Evidence Gathering**

   Evidence encompasses “anything legally admitted at trial that is relevant to the case” (Kranacher, Riley and Wells 2009, 206). Relevant evidence helps provide answers to the “who,”
“what,” “when,” “where,” “how,” and “why” questions developed during the planning and organization stage. The evidence gathering process typically includes the following steps (Sharma, Sherrod, Corgel and Kuzma 2009, 11):

a. *Preservation* involves activities designed to prevent the loss of or destruction of hard copy documents or electronic evidence. Such activities may include boxing up and restricting access to all relevant hard copy documents and making images of all relevant computer hard drives or network drives.

b. *Collection of evidence* encompasses the physical retrieval of the preserved documentation, whether hard copy or electronic. The documentation should then be organized for easy access and review. In a document-intensive case, this can be a labor-intensive but important task.

In the Madoff case, the SEC investigators made two huge evidence collection mistakes. First, when seeking Depository Trust Company (DTC) records in 1992, they requested copies of such records from Madoff himself rather than from the DTC directly. Madoff evidently then fabricated the records and satisfied the SEC investigators. In its review of the SEC’s handling of the Madoff case, the Office of Inspector General asserted that “had they sought records from DTC, there is an excellent chance that they would have uncovered Madoff’s Ponzi scheme in 1992” (OIG 2009, 23). Unfortunately, it was not unusual for the SEC investigators “to rely exclusively on records and data produced by the registrant, even in instances in which the registrant was being investigated for possible fraud” (OIG 2009, 98). Clearly, documents obtained from an independent third party are more reliable than those obtained from the suspected fraudster.

Second, the SEC investigators “drafted a letter to the [NASD] seeking independent trade data, but they never sent the letter, claiming that it would have been too time-consuming to review the data they would have obtained” (OIG 2009, 24). However, since by 2003 Madoff’s investment advisory business had evolved into a Ponzi scheme and was not engaged in trading activities at all, they would have received few, if any, records. Effective investigators typically assume the worst case scenario when testing a fraud theory. As they expected to receive tremendously voluminous records, the SEC investigators apparently assumed that Madoff was *not* perpetrating a Ponzi scheme. Had they more correctly assumed the worst case scenario, they would have expected to
receive few, if any, records and would not have worried about the time required to review them.

c. **Processing** involves the review and analysis of collected evidence in order to answer the primary investigation questions developed during the planning and organization stage. Most importantly, the evidence should be examined “to identify the extent of the fraud, the method employed to perpetrate the fraud, and the individuals involved” (Sharma, Sherrod, Corgel and Kuzma 2009, 11). While processing evidence, it is important for investigators to maintain an objective mental attitude and consider all evidence, including exculpatory as well as inculpatory evidence. During the processing step, investigators need to develop a compelling storyline that answers all of the investigation questions and will be understood by law enforcement and the courts.

The proper sequence of events in an effective investigation should be: (1) identify allegation of fraud, (2) examine documentary and other electronic evidence relevant to the allegation, (3) employ other evidence-processing actions such as surveillance, net worth analysis of suspect(s), financial statement analysis, and interviews of those persons not likely to be responsible for the fraud, and (4) interview likely suspect(s). In the Madoff case, the SEC investigators often went directly from step 1 to step 4 and bypassed completely steps 2 and 3. Consequently, it is not surprising that the SEC failed to uncover Madoff’s Ponzi scheme.

d. **Interviews of appropriate personnel** should usually be conducted after documentary and electronic evidence have been processed and relevant questions have been developed. These interviews have at least three primary objectives. First, to obtain answers to the primary investigation questions developed during the planning and organization stage. Second, to help further clarify the storyline or theory developed during the information and evidence gathering stage. Third, to solicit innocent or legitimate explanations for irregularities identified during the processing of evidence.

Using an example of a fraud case investigated by one of the authors, the owner of an apartment complex projected that at 80% occupancy the complex should begin making money. However, at 95% occupancy, the complex was still losing money. Consequently, the owner became suspicious of the manager, who had complete control of all cash receipts and disbursements. Accordingly, he engaged an experienced, financial
investigator who was both a CPA and a CFE, to investigate. The investigator identified the following irregularities during evidence processing:

- the repairs & maintenance expense was 27% of gross rents received whereas two comparable complexes averaged 10% and 12%, respectively;
- in the checkbook register, 20 entries had been whited-out by someone and all had been charged to the repairs & maintenance expense account;
- the bank statement check images for all of the 20 whited-out entries were missing; and
- all of the 20 dubious entries occurred during a three-month time period.

A subsequent interview of the owner revealed that the manager was building a house during the three-month time period in which the 20 entries occurred. Based upon the above irregularities and the interview of the owner, the investigator developed the theory that the manager had paid for expenses related to the construction of his personal residence using the complex’s checkbook and charged those expenses to the repairs & maintenance expense account. After discovering that the complex was to be audited, the manager whited-out the offending entries in the checkbook register and destroyed the corresponding check images in the bank statements. Note how the storyline was further clarified by the interview of the owner and explains all of the irregularities identified during evidence processing. Ultimately, the manager was interviewed and given an opportunity to provide legitimate explanations for the irregularities. Since he could not legitimately explain the irregularities, he confessed to the scheme and confirmed the storyline developed by the investigator.

**Interviewing Guidelines**

While conducting fraud investigations, “nothing is more important to the successful resolution of a case than the ability to conduct thorough interviews of witnesses,…subjects, and targets” (Kranacher, Riley and Wells 2011, 234). Some guidelines for conducting effective interviews include:

- *Keep questions open-ended, simple, and to the point.* Open-ended questions require an extended narrative response rather than a “yes” or “no” response. Examples: “Tell me about the whited-out entries in the checkbook register.” Or in the Madoff case: “Mr. Madoff, explain how your investment fund, which comprised a basket of stocks from the S&P 100, reported a 6% return during a time period in which the S&P 100
“decreased in value by 38%?” Closed-ended questions are typically used to solicit specific information such as amounts, dates, and times or are asked during the closing phase of the interview to summarize the relevant information obtained.

- **Avoid leading questions that suggest a specific answer.** Instead of asking, “Is that the president’s handwriting on this invoice?” ask “Whose handwriting is on this invoice?” Instead of asking, “Did you pay this invoice twice by accident?” ask “Why are payments to this vendor exactly twice what is owed?” In general, leading questions are only appropriate when seeking confessions or when persuading subjects to make uncomfortable admissions.

- **Listen to understand, not to respond.** When conducting interviews, it is imperative that the interviewer correctly understands the subject’s response before moving on to the next question. This can be accomplished by asking the subject, “Let me see if I understand you correctly” and then repeat back to the subject your understanding of his/her response.

- **Identify hearsay evidence.** Sometimes subjects provide information as if they have direct knowledge of it, when they heard it from someone else or through the company grapevine. Example: “Bill has recently awarded a number of business contracts to his brother-in-law’s business.” To ferret out hearsay evidence, which is not admissible in court, the investigator should routinely ask during investigative interviews, “How do you know this information?” If the answer is “Well, that’s what Clarissa told me,” the evidence is hearsay and the investigator will then need to interview Clarissa. “How do you know this information?” is probably the most important question an investigator should frequently ask during an investigation.

- **Maintain control of the interview.** The information flow in an interview should be from the subject to the interviewer. In general, the person asking the questions controls the flow of information. Instead of responding to the interviewer’s questions, many subjects will attempt to take control of the interview by asking questions of the interviewer. Madoff successfully reversed the flow of information with the SEC investigators by asking them questions to which they responded. Further, when Madoff provided a response, he was often evasive or vague (OIG 2009, 204). When confronted with such subjects, the investigator should re-take control of the interview by telling the subject, “Look, it’s my job to ask the questions,
it’s your job to provide answers.” Effective investigators maintain control of the interview by asking the questions, by not providing information to their subjects, and by not settling for vague responses that leave unresolved issues.

**Recommendation and Reporting**

Once the evidence has been collected and processed and the primary investigation questions have been answered, the results must be communicated to the client, which may include the victim company’s board of directors or an appropriate law enforcement agency. In general, the investigator will first report the preliminary results of the investigation to the client orally before doing so in writing. When preparing the written report, keep in mind that the opposing side will likely obtain a copy of the report and subject it to intense scrutiny in an effort to find anything that could be used to discredit the report’s findings or the investigator(s) who prepared it. Findings may include conclusions and/or opinions, which, although similar, are also distinct from each other. “Conclusions are positions grounded in the evidence, whereas opinions are based on the… [investigator’s] interpretation of the facts. Opinions require the [investigator] to connect the dots. Normally, the conclusions are self-evident” (Kranacher, Riley and Wells 2011, 497). For example, payments made to a shell company – which is a fictitious business on paper only – for which nothing was received in return lead to the conclusion that the organization fell victim to a fictitious vendor scheme. Madoff’s Ponzi scheme, which is a more sophisticated fraud scheme, would require the investigator to examine the available evidence and render an opinion regarding whether Madoff’s investment fund constituted a Ponzi scheme. Before investigators can render legally-admissible opinions, they must first be qualified as experts by virtue of their education, work experience, and/or professional credentials pursuant to Rule 26 of the Federal Rules of Civil Procedure.

**Report Format**

A well-executed investigation can be completely discredited by a poorly written report (Babitsky and Mangraviti 2002). For this reason, investigators can expect to invest a substantial amount of time and effort into drafting a written report that accurately, clearly, and concisely communicates the storyline developed during the processing of evidence. Although report formats may vary, most investigative reports include the following (ACFE 2010, 3.1101 – 3.1148):

- Cover letter to client
- Title page
An effective investigative report should clearly convey all information and/or evidence relevant to the matter under dispute, regardless of which side it supports. Rule 401 of the Federal Rules of Evidence defines relevant evidence as evidence “having any tendency to make the existence of any fact that is of consequence to determination of the action more probable or less probable than it would be without the evidence” (ACFE 2010, 2.703).

**Avoiding Defamation Claims**

When writing the report, avoid drawing legal conclusions, but simply report the facts. In a fraud case investigated by one of the authors, he asserted in the first draft of an investigative report that the target had forged the owner’s signature. Even though the signature was an obvious free-hand forgery – one in which the forger makes no attempt to simulate or copy an authentic signature, but where the forger simply writes someone else’s signature using the forger’s own handwriting style – this was a mistake for two reasons. First, the investigator was not a qualified handwriting expert, so asserting that a signature was forged is an opinion that fell outside his area of expertise. Investigators should never render opinions on issues that fall outside their areas of expertise. Second, the term “forged” is a legal conclusion best left to the judge or the jury to decide. At the advice of retaining counsel, “forged” was changed to “the signature does not appear to be the owner’s authentic signature.”

Accordingly, avoid using words like fraud, embezzle, steal, theft, and forgery, for they all imply legal conclusions, and can also be construed as defamatory. If possible, refer to fraud generally without naming a specific person. Example: “There is evidence of fraud.” Also, the
use of the following well-placed modifiers can help deter defamation claims: alleged, likely, possibly, probably, may or might, and could. The appropriate use of these modifiers can be the difference between acceptable statements and defamatory statements (Windham 2010). Example: “It has been alleged that John committed fraud.” Even if the defamatory statement can be proven to be true, the optimal strategy is to not provide the target with an opportunity to redirect the attention of the court away from his/her own actions to the actions of the investigator by filing a defamation claim.

Confidentiality

Inasmuch as an investigative report contains confidential and possibly incriminating information, the investigator must limit the distribution of the report and avoid discussing the investigative details with outside parties. Rule 301, Confidential Client Information, of the AICPA Code of Professional Conduct states the following with respect to litigation services: “[a] member in public practice shall not disclose any confidential client information without the specific consent of the client” (AICPA 2010).

Similarly, the ACFE Code of Ethics states that “CFEs shall not reveal any confidential information obtained during a professional engagement without proper authorization” (ACFE 2010, 4.1015). In essence, the investigative report and supporting work papers are the property of the client who financed the engagement. The investigator should work with the client in determining the appropriate audience for the report, and should then limit the distribution and use of the report to those agreed upon parties. The client’s written consent must be obtained before the report and supporting documentation can be distributed outside the client.

CONCLUSION

For years Bernard Madoff defrauded thousands of investors out of billions of dollars by means of a relatively simple Ponzi scheme. After receiving six substantive complaints from several credible sources, the SEC conducted three examinations and two investigations, but failed to uncover Madoff’s Ponzi scheme. The SEC investigators failed to uncover Madoff’s scheme because they did not have a sufficient understanding of the following three issues critical to effectively investigating Ponzi schemes: understanding what a Ponzi scheme is and how it works; detecting the red flags of a Ponzi scheme; and conducting an effective Ponzi scheme investigation. This paper provides a foundation to understand these critical fundamental concepts in the hopes that investigators will effectively investigate future Ponzi schemes.
REFERENCES


Windham, J. 2010. Examination ‘bad words’: how CFEs can avoid potential defamation pitfalls. *Fraud Magazine* (July/August): 24-27 and 47.