Lessons for Investors: A Critical Analysis of Bernie Madoff's "Historic" Securities Fraud

Before being arrested, Madoff invested more than $37 billion, but his auditing firm was a three-person accounting firm in a small New York storefront.

COMPILED BY MILES Z. EPSTEIN
EDITOR, COMMERCE

AS VILLAINS GO, BERNIE MADOFF has few peers. He ripped off Holocaust survivor and Nobel Prize winner Elie Wiesel; stole from noted charities and philanthropies; embezzled the life savings of seniors who trusted him; lost family fortunes resulting in multiple victim suicides; and can arguably be blamed for years of losing seasons for the New York Mets, as the owners—the Wilpons—suffered financial losses that many suggest curtailed investment in their baseball team. *COMMERCE* asked the following accountants and attorneys to offer their insights on the "lessons for investors" that can be derived from Madoff's colossal betrayal and criminal Ponzi scheme.

ACCOUNTING

Bederson LLP
By Tim King, CPA, CFF, CFE, Partner

The best "best practice" is prevention. Assess internal controls, take account of potential vulnerabilities and design controls to minimize risk. At the time of the disclosure of the Madoff fraud, everyone wondered how this multi-billion-dollar Ponzi scheme could have happened. The source of the victims' greatest frustration was the lack of a follow-up investigation after questions were raised to governmental agencies about Madoff's empire. Published accounts indicate that after having been notified of possible irregularities, government representatives met with Madoff. A very well respected member of the financial community, Madoff essentially told a compelling story with old anecdotes from his days at Nasdaq, and the meeting was concluded without any subsequent investigation. Had an investigation been initiated, discovery of his scheme would have be evident; as for many years little or no trading activity occurred. All transactions were simply depositing funds from investors and paying dividends. In an investigation, taking the word of the president or some other officer is not sufficient. An investigation must be properly planned and all relevant questions and issues verified. In the Madoff case, had the investigators simply kicked the tires, the fraud would have been discovered much sooner.

Deloitte Financial Advisory Services LLP
By Anthony Campanelli, CPA, CFF, Partner

Even the smallest of details, like an incorrect sequence of invoice numbers, may lead to significant findings. That is why paying attention to details, maintaining a high level of professional skepticism, and being knowledgeable about fraud schemes and potential methods of deceit are essential when it comes to forensic accounting. A forensic accountant should not take facts at face value, but should question and verify the source of the information at hand. Positive returns on investment in difficult times, for example, should have you digging deeper. You simply have to be rigorous in your scrutiny of what's presented. In the Madoff fraud, certain regulators and investigators appeared to have ignored various unexplainable facts regarding Madoff's investments that investors had raised. But these unexplainable facts were red flags that could have led to further vetting. Being aware of fraud tactics used in the past and leveraging learnings to help prevent and detect ongoing frauds is another important leading practice. Ponzi schemes, as used by Madoff, are common, yet were initially ignored by many.

EisnerAmper LLP
By Hubert Klein, CPA, ABV, CFF, CGMA, CFE, CVA, Partner

The ultimate best practices to stop fraud are for businesses to establish internal control systems and procedures designed to deter a wrongful act before it happens. That includes separation of duties, as well as oversight at various stages of the financial reporting process. Fraud prevention best practice principles are built on deterrence and early detection to help minimize the risk (and potential volume) of finan-

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cial loss. In addition, studies show where deterrence programs are circumvented, incidents of fraud are often uncovered due to tips from employees. Therefore, reinforcing the importance of the controls can help build a corporate culture that includes an understanding of the threat of fraud to the business. Training employees to be alert for signs of fraud along with diligent reporting procedures is another effective fraud-fighting tool. In the Madoff case, there was a lack of controls, plus too much control was centered with a few individuals without proper oversight. A more diligent control environment, separation of duties, strong oversight and a fraud-fighting culture could have helped prevent the Madoff fiasco. More people would have been aware of the weaknesses and the attempts to cover up along the way, and someone could have spoken out sooner.

Goldstein Lieberman & Company LLC
By Phillip E. Goldstein, CPA, Co-Founder, Managing Partner

There are three key lessons that can be learned from the Madoff scandal. Lesson one: If someone tells you something that sounds too good to be true, it probably is. Lesson two: If you don't want to be cheated out of money, make sure that you and/or someone you trust is watching it closely. Lesson three: Honesty is always the best policy. Since the Bernie Madoff debacle and largely due to his conviction, the Dodd-Frank Act was passed putting the entire investment industry under greater scrutiny. There are new registration requirements, new rules for exemptions and the SEC now has even greater authority to monitor financial firms. Look at the ads for today's investment firms and notice that clients are now counseled to keep their money in large, reputable institutions where protections against frauds like these are in place. Investors are also advised to demand greater transparency and be active participants in the entire investment process. We have always performed comprehensive due diligence about any financial transactions we might recommend. We have always provided insight and clarity into every aspect of our business relationships, including what fees will be charged for what services.

Grant Thornton LLP
By Charles Blank, CPA, CFA, Managing Director

The Madoff Ponzi scheme was another clear example of an affinity fraud that opened the eyes of the broader public as to how a fraud could have such far reaching and significant negative financial impacts on its victims. Madoff's fraud and many other Ponzi schemes were uncovered around this time through the sudden downturn in the markets and the resulting redemption demands by investors. These events brought to light schemes that are familiar to those that practice forensic accounting. That is, an investment opportunity where there is a lack of transparency by the investment manager with the promise of returns that seem inconsistent with the overall market. It reinforces the need to do adequate due diligence before making an investment such as reviewing audited financial statements, a public record search of the investment manager, and talking with other investors. These are some of the forensic procedures we often perform when the alleged fraud comes to light.

Hunter Group CPA LLC
By Kevin J. Hansen, CPA, Co-Managing Director

I think there are two very simple lessons investors and business owners can learn from the Madoff breach of trust—be vigilant and don't take everything at face value. If there was a third lesson, it would be reinforcement of the adage, "If it sounds too good to be true, it probably isn't." While essential to keep a positive outlook on humanity, business owners nonetheless must periodically examine mundane business activities. Uncovering a covert Ponzi scheme operating in your company is unlikely, yet employees (even family members) may be misappropriating business assets for their own benefit. Your due diligence may also uncover ways to improve and protect the company from abuse and waste. Randomly spot checking everything from purchasing to payroll, accounts payable, and even the mail can shed a light on unusual activities. Do paychecks reflect a correct rate of pay? Do you have 41 employees and 45 paychecks processed? Are there large checks being cut for mysterious vendors? Examine inventory, supplies and credit card charges for oddities as well. While every business is unique, proper financial and operational controls are fairly standard. Don't have the time? Consider hiring outside auditors for the task. You will gain peace of mind and perhaps improve your operations in the process.

Levine, Jacobs & Company, LLC
By Michael H. Karu, CPA, CFF, Member in Charge, Litigation and Valuation Services Group

In the post-Madoff era, the greatest lesson learned was "if it sounds too good to be true, it probably is." The first indication that something was amiss was the offering of double-digit returns at a time when 4 percent to 5 percent was the standard. That, alone, should have been sufficient to warrant investigation. Ponzi schemes have been around since

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the 1920s when Charles Ponzi promised investors a whopping 50 percent return in 45 days, or 100 percent in 90 days, on international postal coupons, which he never actually purchased. Forensic practices are employed to protect the investors. Before investing, a savvy investor should perform due diligence. However, anyone who is involved with scamming the public would simply refuse to release any financial records and would reply with something like, "If you aren't sure, then don't invest. We've got plenty of others lined up." If a potential investor comes to us with this sort of story, our advice is to stay far away. After all, everything is based in logic. For publicly traded investments, oversights should be in place. For any non-publicly traded investments, there needs to be a logical explanation for their success supported with hard data. If that combination doesn't exist or cannot be verified, our advice is to pass.

Marks Paneth LLP
By Steven L. Henning, Ph.D., CPA, Partner-in-Charge, Advisory Services

Cases of serious investment fraud seem to hit the headlines with depressing regularity these days. When they do, the investigations and the eventual litigation inevitably require forensic accounting expertise. Whether clients have been the victim of, or are litigating cases involving allegations of fraud, embezzlement, money laundering or fraudulent financial reporting, forensic accountants are often called in to provide a broad range of services. Forensic accountants use well-established, proven methods and leverage their expertise in accounting and financial practices to uncover deceptive practices and unmask fraudulent financial transactions. Utilizing a wide range of state-of-the-art software applications, they can review vast numbers and types of transactions. Plus, they can identify and trace funding sources and transactions; undertake the financial analyses of business and personal records; develop financial profiles of those suspected of fraud; and uncover illegal activity, no matter how carefully hidden. Forensic accountants also gather evidence and prepare affidavits; compile findings into investigative reports; and provide litigation support and expert testimony in judicial proceedings. Behind the headlines you'll find forensic accountants hard at work.

PKF O'Connor Davies, LLP
By Keith S. Balla CPA, PSA, ABV, CFF, CGMA, Partner, Forensic, Litigation & Valuation Services

Forensic Accounting goes beyond auditing. Clients retain forensic accountants when there is suspicion about the "true" economic activity. Most forensic matters typically involve investigating fraud or theft in a business, but some may require valuation services. Forensic accounting is not simply looking at documents. We interview knowledgeable people in the business—not just the business owners—and verify inside information with outside documentation. We develop a deep understanding of each facet of the operations. We research the industry and the relationships between the company, persons, customers and suppliers. Often we use computer software to look for patterns within the data to unearth areas for more in-depth investigation. The key qualities are: observant; inquisitive; diverse experiences; ability to get people to open up and communicate and suppress their natural defenses; and finally be thorough and detailed. A lesson learned from Madoff—annual audits will not unearth the frauds that can be perpetrated by greedy individuals. The Madoff scandal saw both large and small firms rely on insufficient documentation. It is clear that greed influences decisions. No matter the size of the accounting firm, allowing fees to dictate decision-making creates an environment for compromising of professional duty.

Sobel & Co., LLC
By Rebecca B. Fitzhugh, CPA, CFF, CFE, MBA, CIT, CIGA, Member, Forensic Accounting/Litigation Practice

Professional skepticism and common sense are vital best practices in forensic accounting, as well as in any profession. One should always ask questions, apply basic analytical principles and not be blinded by "trust." Two aspects of the Madoff Securities fraud that stand out to me are the overly complex methodologies Madoff allegedly used and the level of trust people had in him. The securities industry involves some notoriously complex concepts, making it easy to fool unsophisticated investors. When someone is using processes or statistical formulas that are unusually convoluted, and few can understand them, this must be considered a red flag for investigation. Madoff had a long and illustrious career in the financial industry, and nobody knows when he actually initiated his scheme. He sat on the board of the National Association of Securities Dealers and advised the Securities and Exchange Commission. These roles conferred upon him a degree of perceived trustworthiness that allowed him to grow his Ponzi scheme to an unprecedented level. If you take blind trust out of the equation, and conduct your due diligence in the same way for everyone, regardless of an individual's reputation, you are less likely to be victimized in this way.

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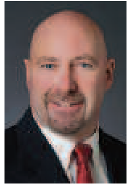


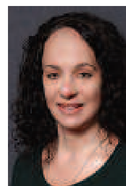
WithumSmith+Brown, PC
By Jack O'Donnell, CPA, CFE, CVA, CFF, Fraud/Forensic Accounting Practice Leader

As Ponzi schemes go, Madoff's was a bit different than the typical Ponzi scheme because he actually ran a brokerage business. Most Ponzi schemes are merely fronts for nonexistent businesses where the schemer attracts unsuspecting investors by promising high returns, but in reality uses their investment to pay the promised returns to previous unsuspecting investors. The scheme can only survive by enticing new investors since no profits are ever earned through legitimate investment sources. Madoff was a master marketer and he positioned his business to be exclusive so that investors believed his expertise was not available to the general public. As a result, Madoff investors were wary of removing their money from his fund in case they could not get back in at a later date. In addition, he did not promise extraordinary investment returns; his annual returns were consistently around 10 percent, which allowed the fraud to continue for so long. To prevent being a victim of the next Bernie Madoff, be skeptical of promises and sales pitches; be wary of exclusive offers; perform thorough due diligence on your broker with the regulatory authorities; and ask for references or referrals and follow up with them.

LAW

Connell Foley LLP
By John P. Lacey, Esq., Partner, White Collar Criminal Defense Group

Bernard Madoff's investment scam taught investors some valuable lessons: pay attention to your investments—earning consistent monthly profits regardless of what the market is doing is a red flag; there's no perfect investment strategy—if anyone tells you he/she has discovered the "holy grail" "of investing, take your money and run; use reputable brokers and invest in well-known funds; be wary of a broker who caters only to a small undiversified group, as he/she might deliberately exclude persons who are likely to be skeptical of the broker's investing methods; read all monthly and annual statements very carefully; the reputation of the individual running the investment fund matters, but it should not be the determining factor in deciding with whom to invest; avoid any broker who is conspicuously wealthy—remember, all of those expenditures are the result of profits received from investors. The overall lesson is play it relatively safe and do not strive to obtain returns that are not practical.



Norris McLaughlin & Marcus, P.A.
By Melinda Fellner Bramwit, Esq., Partner

Here is the best take away from the events of the Ponzi scheme involving Bernard Madoff: do not refer to anyone who invested in Madoff's firm (BLMIS) as a "net winner." The now famous concept of being a "net winner" from this scandal, coined by the Trustees in charge of administering the bankruptcy proceedings, means that you were a person who took out more principal from your BLMIS account than you initially put in. This is opposed to a "net loser" who, accordingly, lost principal in addition to the earnings which all victims lost. We should all recognize though that all of these people lost, so perhaps the Trustee should have chosen a better moniker. It's been seven years since the December 2008 turmoil. What is a person to do who perhaps, as a net winner, must pay back to the Trustee some amounts previously reported as income? These are not additional theft loss deductions. The IRS treats these payments as repayments that result in either a deduction as a non-theft investment loss or a credit calculated under Section 1341 of the Internal Revenue Code. (Consult a tax practitioner as to your particular circumstances, if affected.)

Scarinci Hollenbeck
By Joel N. Kreizman, Esq., Partner Co-Chair, Litigation Group

As an investment advisor and broker, Bernie Madoff produced great returns. As the word spread about him, prospective investors came to the seemingly rational conclusion: "I'm better off investing with Madoff; my broker is only getting me a 5 percent return, but Madoff can get me 12 percent to 15 percent." As a lawyer, I have seen a similar thought process affect a number of my colleagues. One such individual, during the real estate boom in the early 2000s ("everybody's making a fortune on real estate") bet the proverbial ranch on property investments and eventually filed for personal bankruptcy. Another colleague, hearing of the cash to be made owning a bar, ended up being criminally charged by the IRS and losing his law license. The lure of quick, easy money is hard to resist. Yet that lure is often an invitation to disaster. The lesson to be learned is stick with what you know—invest conservatively and with caution. ■

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