Professional competence and business ethics: SEC and the persistence of Madoff's fraud

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ABSTRACT

The case is based on the well-publicized securities fraud engineered and carried out by Bernie Madoff and his firm. The main focus of this case is on the actions of the Securities and Exchange Commission's employees in response to the reports of Madoff's alleged malpractice. The case introduces basic ethical theories, including the ethics of acquisition and processing of knowledge for decision-making. Students must read the whistleblower's report and the report of the SEC's Office of Investigations to conclude whether competence is an ethical obligation and whether the SEC's actions represented ethical violations. The case discusses behavioral biases that interfere with ethical processing of information for sound decision-making.

Keywords: business ethics, whistleblowing, financial fraud, financial services, regulatory agencies.

Note: All persons mentioned in the case and case materials are real participants in the events. The facts of the case are true and accurate.

INTRODUCTION

A Ponzi scheme created by Mr. Madoff was the largest and the most damaging case of financial fraud in history. The size of the Ponzi scheme has been estimated to reach $20 billion, with about 30,000 victims. It is obvious that Madoff's actions were unethical; moreover, they were criminal. However, *this case shifts the focus onto the failures of the entities that are put in place to prevent such abuses of investors' trust, specifically the Securities and Exchange Commission*.

Forensic investigators were not able to identify when exactly the Ponzi scheme commenced: Madoff himself claimed that the wrongdoings started in the early 90s, while some witnesses dated them back to the 70s, to the inception of Madoff's investment firm. Over the years, prior to his confession and arrest, Bernie Madoff rose to high prominence in the industry. He pioneered the introduction of computer screens and electronic communication into trading, and spearheaded the creation of NASDAQ. He also served as the Chairman of NASDAQ during the early years of the electronic marketplace.

As a result, Madoff enjoyed an impeccable reputation among the investing public, as well as most of the investments industry professionals and regulators. However, towards the late 90s and early 2000s, some analysts started to voice skepticism regarding the credibility of Madoff's reports of returns produced for his investors. Finally, a whistleblower, Harry Markopolos, filed a report with the Securities and Exchange Commission in which he suggested that Madoff's firm is running a Ponzi scheme. This report was followed by several other attempts to prompt the SEC to act on the suspected fraud, all failing in their mission. According to the *Wall Street Journal*,

> "…A nearly 500-page report by the SEC's inspector general in 2009 concluded that substantive, specific complaints and news articles over 16 years should have raised significant questions about whether Mr. Madoff was trading.
>
> Yet during three examinations and two investigations, the agency never gave him 'thorough and competent' scrutiny, for instance by independently verifying his trading, the inspector general found."[1]

As consultants engaged by the SEC after the fallout from the Madoff case, analyze what caused the inability by the agency to prevent the fraud.

Were the Securities and Exchange Commission's actions unethical? Did the SEC employees act with the intent to cause harm to the investing public? Did they follow the rules in their responses to the allegations of Madoff's wrongdoing? Was their failure to prevent or stop the fraud an exceptional occurrence or a failure of the system? Can a remedy be proposed to head off such failures in the future? Can an answer be drawn from a better knowledge of ethical theory?

The first section of this case introduces ethical theories. The second section introduces behavioral and cognitive biases. The third section briefly describes the events leading to Madoff's confession of fraud. The fourth section concludes the case.

[1] https://www.wsj.com/articles/bernie-madoff-dead-at-82-disgraced-investor-ran-one-of-the-biggest-ponzi-schemes-in-history-11618408844

ETHICAL THEORY

Influential Theories of Ethics

Modern ethics rely on three influential theories: ethics of consequences, ethics of rules, and virtue ethics.

Ethics of Consequences: Ethics of consequences, aka *consequentialism* or *utilitarianism*, proposes that a moral act is an act that results in a beneficial outcome. Classic utilitarianists, such as John Stuart Mill, present this view in a form similar to a mathematical model. One version of this "model" states that an act is ethical if it creates good for the majority, even if it brings bad outcomes for some. Others argue that it's the "net amount" of good that matters, rather than the number of people that benefit or suffer from the act: in other words, they introduce the "intensity" of good and bad. Critics of utilitarianism point out that it is hard to call an act ethical if it brings on any suffering, and that suffering cannot be outweighed by the "greater good."

Ethics of Rules: The most prominent proponent of the Ethics of Rules (*Deontology)* is Emmanuel Kant. Kant proposed that moral actions stem from the sense of duty, and that it is the motive behind an action that is important rather than the consequences of the action. It follows that if an individual observes a set of rules in all her actions, she will lead a virtuous and ethical life. Critics of this approach point out that no set of rules can ever include all the various and complex scenarios individuals face on a daily basis. It is also interesting that most organizations incorporate this approach into their ethics programs by creating Codes of Ethics to be followed by members (employees). This is also similar to the way ethical norms are dictated in religious teachings.

Virtue Ethics: The oldest approach to achieving ethical behavior is known as Aristotelian Virtue Ethics. As the term suggests, this ethical theory is known to us from the works of Aristotle (384 B.C. to 322 B.C.); it was later supported and further developed by Thomas Aquinas (1225–1274). This theory proposes that an individual who possesses moral values, or virtues, will inevitably act ethically, without a need for a set of rules or complicated weighing of good outcomes versus bad outcomes. These moral values include courage, love, kindness, temperance, justice, and humility. According to virtue ethicists, one does not have to be born with these qualities to act ethically. It is an individual's responsibility to work hard at acquiring these properties. The process may be easier for some and more difficult for others; however big the effort, it needs to be applied to obtain these moral values.

Epistemic Ethics: Ethical acquisition of knowledge and finding truth

Ethical theories that describe an ethical process of acquisition of knowledge and search for truth are called Epistemic[2] Ethics. Virtue ethics, introduced in the previous section, brought forth an extension known as "Virtue Epistemology", which applies moral values to cognitive process. How can one apply moral values to learning and decision-making?

Proponents of epistemic ethics explain that one should possess:

- the love of knowledge,
- courage in "stretching your mind" to new ideas,
- kindness in considering others' opinions,
- temperance (or restraint) in gathering and processing evidence before forming an opinion,

[2] From Greek "episteme", which can be translated as "knowledge" or "understanding".

- justice in considering all sources of information and giving them equal weight, regardless of a source's hierarchical position or similarity/difference from you,
- humility in weighing your own ability, knowledge or opinion against differing views or additional information.

In the same vein as with the moral values in a more general sense, an effort is required to develop epistemic virtues. Certain areas of human activity require especially high level of epistemic virtue, resulting in what one may call "competence." Professionals, such as doctors, aeronautical engineers, and architects have an especially high responsibility to develop these qualities. Similarly, since we trust finance professionals to make the right decisions that would affect our lifetime savings, finance professionals also have a responsibility of high professional competence, which can only be achieved by "epistemically virtuous" individuals.

BEHAVIORAL BIASES

Epistemic values which lead to ethical decision-making can be developed. Moreover, it is an individual's obligation to work hard on developing both good moral character and good epistemic character, leading to professional competence. However, various behavioral and psychological biases encumber this process and make it difficult to embrace good epistemic habits.

The concept of behavioral biases gained importance in financial theory and practice as an explanatory factor of investors' behaviors. Behavioral finance introduces a correction to the efficient market hypothesis and to the assumption of investors' economically rational behaviors. But influence of behavioral biases extends beyond investment behavior. They can also explain why individuals make suboptimal decisions in other areas, and even why "good" people sometimes do "bad" things (act unethically). Behavioral biases can be categorized into emotional and cognitive biases, and both types ultimately lead to poor decisions, often detrimental not only to the decision-maker, but also to others. Below is a non-exhaustive list of cognitive biases with a brief description of each.

- Obedience to authority motivates people to act in such a way as to please those who they perceive as powerful. This quality goes beyond following direct instructions: decision-makers tend to form opinions regarding an authority figure's preference and act accordingly.
- Cognitive dissonance is a condition where a change in beliefs is psychologically uncomfortable. An individual would ignore new facts if processing and incorporating these facts would result in a change in prior belief.
- Conformity bias reflects the discomfort an individual experiences when her views differ from those of her peers and authority figures.
- Groupthink is related to both conformity and cognitive dissonance biases. Groupthink and influences attitudes in such a way that a consensus is valued more than the truth. It results in pressure to withhold dissent and stifle differing opinions.
- Belief perseverance describes a tendency to ignore new facts or to adjust them to accommodate prior beliefs.

MADOFF INVESTIGATIONS

Bernie Madoff rose to a prominent position in the industry in the mid-eighties. A personable individual with a manner that commanded respect, he started a legitimate and successful investment advising business in the 70s. However, soon the business expanded through what amounted to a Ponzi scheme due to a cultivated reputation of generating superior returns by using a (fictional) split-strike conversion investment strategy. A *Wall Street Journal* article reports:

> "…Mr. Madoff exuded respectability and cut an aristocratic figure, with a mane of silver hair. He enticed victims with an air of exclusivity, luring investors to plunk down huge sums by threatening to turn them away. Mr. Madoff let it be known that he wouldn't be bothered with clients who couldn't invest enough. He was famously secretive about his methods, adding to the allure—and allowing him to escape detection."[3]

Respect and awe enjoyed by Bernie Madoff was not due to his personality alone. Mr. Madoff had a legitimate claim on being a part of the force that revolutionized the investment industry. He was among the first who introduced and used computer screens to report prices and conduct trading, which ultimately led to the creation of NASDAQ, a formidable competitor to the monopoly of the New York Stock Exchange. Madoff served as a chairman of NASDAQ in the early 90s, which solidified his position as one of the respected captains of the industry. It is not surprising that investors of all walks of life, from middle class individuals to European royal families, were eager to entrust Madoff's firm with their money.

The confounding aspect of Madoff's story is the long time that it took to uncover the Ponzi scheme. In fact, Madoff had to reveal the scheme himself, when the financial crisis of 2008 triggered multiple clients' requests to withdraw their funds. It is not clear how long the fraud would have persisted if the Great Recession of 2008 had not created the liquidity crunch.

In reality, not all the market participants had been blinded by the Madoff personality and his reputation. Other investment companies, who had been following Madoff's apparent and consistent success, endeavored to replicate his investment strategy.

One of these companies was Rampart Investment Management Company, Inc., which retained a financial analyst named Harry Markopolos to replicate the "split-strike conversion" strategy to which Madoff attributed his success. As a result of this effort, Markopolos' team concluded that this strategy could not have produced the result claimed by Madoff. Moreover, it was evident that the trades claimed by Madoff to have produced such spectacular results had never been executed. The sheer volume of the trades, according to Markopolos, would not have gone unnoticed by the market.

Convinced that Mr. Madoff was running a fraudulent operation on a large scale, Mr. Markopolos alerted the Securities and Exchange Commission of his discovery. However, the SEC office ignored this first report (2000) and did not contact Markopolos. A repeat submission in 2001 met with the same (lack of) response. Markopolos attempted to contact the SEC again in 2005 and 2006, but the agency projected a mistrustful and dismissive attitude toward the whistleblower in their interactions with him.

As a result, Madoff's deception scheme was allowed to persist for eight years following the first formal complaint.

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[3] https://www.wsj.com/articles/bernie-madoff-dead-at-82-disgraced-investor-ran-one-of-the-biggest-ponzi-schemes-in-history-11618408844

SEC's Office of Investigations later reported that

> "…the SEC conducted two investigations and three examinations related to Madoff's investment advisory business based upon the detailed and credible complaints that raised the possibility that Madoff was misrepresenting his trading and could have been operating a Ponzi scheme. Yet, at no time did the SEC ever verify Madoff's trading through an independent third-party, and in fact, never actually conducted a Ponzi scheme examination or investigation of Madoff."

CONCLUDING REMARK

Imagine a scenario where you are assigned a task to discover whether there is a systemic underlying reason that caused the SEC failure in Madoff's fraud case, and what measures can be taken to eliminate the source of the breakdown. These questions will help structure your report.

1. Can you identify behavioral biases in the actions of SEC supervisors and employees? Please elaborate how these biases resulted in the SEC's failure to detect Madoff's fraud.
2. Was it a lack of epistemic values that prevented SEC supervisors and employees to uncover the Ponzi scheme? Which epistemic values, specifically, would have allowed the SEC staff to be successful in exposing Madoff's firm?
3. Discuss the CFA Institute's Code of Ethics. Which ethical theory proposes that the Code of Ethics is an effective tool? Do you think this tool contributes to ethical behavior of the holders of CFA designation?
4. Do you think competence is an ethical responsibility of finance professionals? Discuss and justify your response.
5. How can SEC employees be better prepared to be a part of an effective watchdog agency?

LIST OF REQUIRED READING

1. Markopolos' Testimony
2. U.S. Securities and Exchange Commission Office of Investigations' "Report of Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme" ("OIG Report")
3. CFA Code of Ethics

TEACHING NOTES

Synopsis

Madoff's Ponzi scheme is probably the best known and most infamous case of financial fraud in history. The most astonishing aspect of this case is the duration of the scheme. Madoff was able to hide behind his reputation for decades, inspiring awe and respect not only among his employees, but also among financial regulators.

This case is different from other cases describing ethical violations in two aspects. First, it focuses not on the main perpetrator himself, but on the bodies that are in place to prevent or detect the actions that bring harm to the financial markets and the investing public. Second, it focuses not on the general ethics, but specifically on epistemic ethics, which is a necessary component of what is generally known as "competence."

Case Use

This case is appropriate in junior and senior level finance classes, specifically Investment Management classes. It is also well suited to a general MBA-level finance class, as well as an Investments class in Masters of Finance programs. In addition, it can be introduced as a part of any class focusing on the practice of ethics and business ethics.

Case Objectives

This case can be presented as a part of an ethics education unit in an Investments Management class in undergraduate or graduate Finance programs, as well as a Financial Management class in general MBA programs. Shifting the focus to epistemic ethics represents an opportunity to introduce ethical theory. This is a departure from more conventional ethics cases, where the various visions of ethical outcomes are not a part of a discussion. After working on the case and reading the required supplemental documents, the students will acquire the skill to more accurately identify ethical or unethical behaviors and actions. Students will learn to use critical thinking skills to apply theoretical concepts to real-world situations, identify behavioral biases and epistemic values present or missing in the SEC's actions, and suggest an alternative course of action. In addition to having a theoretical component, it introduces a well-known case of ethical breakdown, but it allows students to appreciate the complexity that is usually a part of any such case. The case can be structured as individual or group work.

Teaching Objectives

This case has six teaching objectives:

1. Develop an awareness of various ethical theories
2. Develop an awareness of epistemic ethics as a background of the duty of competence
3. Assess the importance of the duty of competence for investment professionals and regulators of the financial markets.
4. Evaluate and understand the ways behavioral biases may interfere with epistemically virtuous behavior and result in non-optimal decisions which may harm the public.
5. Explore the implications of violating the duty of competence.

6. Use ethical theory to propose a solution to minimize violations of the duty of competence.

Discussion Questions

1. Can you identify behavioral biases in the actions of SEC supervisors and employees? Please elaborate how these biases resulted in the SEC's failure to detect Madoff's fraud.
2. Was it a lack of epistemic values that prevented SEC supervisors and employees to uncover the Ponzi scheme? Which epistemic values, specifically, would have allowed the SEC staff to be successful in exposing Madoff's firm?
3. Discuss the CFA Institute's Code of Ethics. Which ethical theory proposes that the Code of Ethics is an effective tool? Do you think this tool contributes to ethical behavior of the holders of CFA designation?
4. Do you think competence is an ethical responsibility of finance professionals? Discuss and justify your response.
5. How can SEC employees be better prepared to be a part of an effective watchdog agency?

Teaching and Discussion Suggestions/Answers

The nature of this case does not require precise answers or solutions. Students are expected to use analytical thinking skills to make connections between the theory of ethics and practical application of that theory. Below are some brief suggestions of how students may approach the discussion questions.

1. Can you identify behavioral biases in the actions of SEC supervisors and employees? Please elaborate how these biases resulted in SEC's failure to detect Madoff's fraud.

According to the OIG report, SEC employees had a *prior belief* in Madoff's investing prowess, that his reputation in the industry was well-deserved and that his expertise exceeded the expertise of the investigators themselves. The investigators were reluctant to thoroughly investigate whether the whistleblowers' claims were true, to protect the prior belief from new information, and to avoid *cognitive dissonance*. Madoff's reputation as one of the "captains" of the industry created *groupthink*, and the investigators, many of which were at the early stages of their careers, felt safer *conforming* with the majority's views. Page 50 of the Report states:

> "…Gentile and Vasilakis became aware of Bernard Madoff's stature in the securities industry during the examination. Gentile stated that he was aware that Madoff's firm "was very prominent in developing third market particular automated trading." Gentile Interview Tr. at p. 10. Vasilakis stated he was made aware that Bernard Madoff served on various industry committees, was a well respected individual and noted that the SEC examiners used an NASD manual with Bernard Madoff's name in it…"

2. Was it a lack of epistemic values that prevented SEC supervisors and employees to uncover the Ponzi scheme? Which epistemic values, specifically, would have allowed the SEC staff to be successful in exposing Madoff's firm?

Practicing epistemic *justice* would have prompted the SEC to give the same weight to the claims of a whistleblower as to Madoff's responses. Madoff's interview responses had been taken at their face value, no facts were checked independently through a third party.
If SEC supervisors practiced epistemic *humility*, they would have taken Markopolos' reports more seriously. According to Mr. Markopolos' testimony, they were dismissive and arrogant, unwilling to acquire knowledge necessary to understand the basis of Markopolos' claims, nor were they willing to engage an expert to check those claims.

SEC employees lacked epistemic *courage* to confront their prior beliefs of Madoff's superior expertise and character.

SEC should have exhibited *temperance* in their investigation of Bernard Madoff, to not succumb to the temptation of a quick verdict. They should have patiently examined all the evidence and checked all claims.

Finally, the *love* for knowledge should have fueled the examiners' pursuit of the truth behind both Madoff's operations and the whistleblowers' reports.

3. Discuss the CFA Institute's Code of Ethics. Which ethical theory proposes that the Code of Ethics is an effective tool? Do you think this tool contributes to ethical behavior of the holders of CFA designation?

CFA Institute's Code of Ethics is a tool that follows the Ethics of the Rules (Deontology) school of ethical thought. Codes of Ethics, that are, essentially, a set of rules for employees or members to follow, can never list all possible situations or reflect life in its complexity.

However, Codes of Ethics have proven to be effective in organizations. It is unrealistic to expect that each incoming employee has a solid background in all aspects of ethical theory and practice, nor it is viable to offer such training at a workplace. Codes of Ethics are a practicable first step to ensure awareness of ethical pitfalls and offer possible actions to avoid such pitfalls.

4. Do you think competence is an ethical responsibility of finance professionals? Discuss and justify your response.

CFA Institute's Code of Ethics states:

"…Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates") must:

- Act with integrity, *competence*, *diligence*, respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.

…….

- Maintain and improve their professional *competence* and strive to maintain and improve the *competence* of other investment professionals. "

Investment professionals, as medical professionals, engineers and other members of the society who perform knowledge-based services, have an ethical duty to develop *epistemic values*, in addition to moral values in a more general sense. It would harm a patient if a doctor were to suggest a diagnosis or to offer medical advice without thorough research of a patient's history and symptoms, and without comprehensive knowledge of current medical theory. Similarly, investors would come to harm if an investment analyst were to issue a recommendation or an advisor to suggest an investment strategy without thorough research and knowledge of current theory of finance. Thus, the sources of unethical behavior are not restricted by a conflict of interest, but may also include incompetence and lack of epistemic virtues.

5. How can SEC employees be better prepared to be a part of an effective watchdog agency?

Security and Exchange Commission should follow the industry that it regulates in adopting a comprehensive Code of Ethics. However, that would be a first step. This recommendation is appealing because it is easy to implement, and it has been shown to be effective. In addition, the SEC should hold regular ethics trainings and modules. Specific content of the Code of Ethics and Ethical education for SEC employees should include the Duty of Competence requirement, and the training sessions should include the theory of general ethics and an overview of virtue epistemology.

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