

## Club Madoff

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*Abstract: This paper will be discussing the factors that go into the thought process of a financial criminal, in this situation, Bernard Madoff, and the thought process of those who are willing to invest. There are several instances every few years where smart and famous men find that their legitimate success and it is not enough, so they lurk into the illegal activity of financial scams and schemes to swindle investors. Not only do these criminals find ways to scam us, but the blame also lies on ourselves for not being thorough in our research behind investments. The thought process of an investor becomes blinded by the excitement of getting rich quick, not realizing they're getting themselves into the pyramid. As disheartening as the information is, the paper also shows that there are many precautions we as investors can take when looking to invest our money.*

### Club Madoff

Regarding Bernard Madoff, a man at work once told me: “After he shook my hand, I made sure my arm was still there.” He had met Madoff several times, and was even invited to his annual holiday parties. In 2009, Madoff was formally charged with 11 felony counts all connected to his financial Ponzi scheme that had been going on for decades. He had been scamming countless investors, individuals, and institutions; promising them high returns on all of their investments. Eventually, the Ponzi scheme collapsed and Madoff was caught. By the end of the scam, he had swindled a total of \$50 billion. By no means was this the first time people were fooled by schemers in the investment world. In the 1920's, immigrant Charles Ponzi (for whom the Ponzi scheme is named) had promised enormous returns to investors, as with Madoff. Once the pyramid of the scam collapsed, his investors lost their savings and Ponzi was sent to prison. Every few years it seems that a swindler is caught in a financial scam, causing investors to lose most, if

not all, their money.

One would think that as time goes on, these types of scams would not happen as often.. And yet still, some financial schemer thinks he can make millions on investors. So, what made Madoff in particular think he could get away with scamming his investors? And more importantly, why did they fall for it? The answer to both of those questions can be answered in several ways. As investors, our brains go through a psychological process of the information we receive about the investment, leading us to convince ourselves we won't be the ones who get ripped off. The deep-seeded urge to make money without working for it grows within us. Increasing psychological evidence compares swindlers' thought processes to those of violent criminals. In the midst of the corruption and mistrust, there are some solutions and preventative measures investors can take to avoid investing in a legitimate enterprise.

### **Background**

Before going into the research and solutions, it's important to go over terms and types of scams that have been and will continue to be foisted on the gullible. The most popular financial scheme is called the pyramid scheme. Investors put in money and are promised unusually high returns. The only way to get their returns is to get more investors to put in a greater amount of money. Schematically, this investment structure looks like a pyramid. The more investors, the more money made. The reason why the pyramid scheme fails is because a pivotal event causes most, if not all, investors to want out of the deal simultaneously, which makes it difficult or impossible to get the return they were promised. When the deal collapses, the schemer and the scam are revealed.

Madoff had already found success and fortune doing work with his own business involving investment securities, prior to the planning of his Ponzi scheme., In a Ponzi scheme "invested money is pocketed by the schemer and investors who wish to redeem their money are actually paid out of proceeds from new investors" (Greenspan). Like the pyramid scheme, Ponzi's scheme failed, when all of his investors discovered that

the international reply coupons (IRC's) they bought were not generating the returns Ponzi promised them (McArdle).

For Madoff, it was the financial crisis in 2008 that caused every investor to attempt to simultaneously cash in on his or her returns, and Madoff was left with insufficient funds. Though he had tried incredibly hard to keep the scandal low profile and under his control, the scheme was revealed when he was betrayed by his two sons Mark and Andrew Madoff, who reported him to the Federal Bureau of Investigation (FBI). Madoff's downfall was that the success in his legitimate business was not enough to feed his appetite for more and more wealth. Therefore, something far more lucrative, though risky, was called for. Madoff's Ponzi scheme was born.

### **Why We Fall For It**

It seems difficult to understand how people can be so gullible as to invest in a scam without even knowing it. But in fact, it is more likely than we think. The reason so many people fall for it is because of their internal thought processes when receiving information and making decisions on it. Author and psychologist Stephen Greenspan proposes a "multidimensional theory" in *Annals of Gullibility*. In his book, he explains how we convince ourselves that we are not the silly ones investing in a bogus scheme. Greenspan explains that there are four factors to our gullibility: situation, cognition, personality and emotion. Ironically, after writing his book, Greenspan himself fell victim to Madoff's scheme and lost most of his retirement fund.

Investors were motivated by the social life Madoff led. He had built a brand around him, and investors were itching to see how rich Madoff could get them. What makes Bernie Madoff brilliant is the way he would psychologically manipulate his investors to believe that they belonged to an exclusive club when they invested with him:

...his customers accepted that 'to ask Bernie to reveal his strategy would be as crass as demanding to see Coca-Cola's magic formula.' Angering Bernie might kill the goose that laid the golden egg; he had tossed a couple of disrespectful clients

who got too nosy about how the money was being made...

People didn't question Madoff's absurdly, unrealistically high returns because if they did, they would lose their shot at making that risk-free 10 percent a year. (McCardle)

Madoff created his image as a financial genius, by making anyone who chose not to invest in his funds jealous. Anyone who questioned Madoff's system was tossed out. Madoff made sure that his scheme was not too obvious. Instead of promising gains that seemed extremely suspicious to investors, he promised modest but steady gains. "A big part of Mr. Madoff's success came from his apparent recognition that wealthy investors were looking for small but steady returns, high enough to be attractive but not so high as to arouse suspicion" (Greenspan, [www.wsj.com](http://www.wsj.com)). Investors, and Greenspan in particular, felt secure putting their funds into his hand because he proposed the idea that "slow and steady wins the race".

Cognition, how we interpret the information we are given, can be linked to intelligence, but even the most intelligent people can still be conned into a scam like Madoff's. We convince ourselves that everything is fine and that there are no red flags we should be aware of. If we do see a red flag, we try to pretend we never saw it. The more we invest, the more we want to believe what we are doing is the right thing. The best way to show this theory is the launching failure of space shuttle, the Challenger. The night before the shuttle was expected to launch, the engineers who built the Challenger had started to have doubts behind the safety of the mission. They strongly suggested to NASA that they not launch the shuttle. NASA was not happy about the suggestion, as they really wanted to launch the Challenger during the new wave of space technology. They asked their engineers to make a "management decision" and with much fear, they still went on with the mission. "When it became clear that NASA didn't like the 'don't launch' recommendation, Morton Thiokol managers consciously (or subconsciously) realized that their reward was in jeopardy. And they reacted to protect that reward" (Bazerman et al, [www.freakonomics.com](http://www.freakonomics.com)).

com). Because of the exposure that this launching had, those involved still wanted to attempt it and disregarded the potential for disaster. Similarly, we try and tell ourselves that despite something seeming awry, our financial choices are the right choices and will come out successful.

The third key factor deals with personality. Are you a "yes man"? If so, you are more predisposed to fall victim for a scam. For Greenspan, "trust and niceness were also accompanied by an occasional tendency toward risk-taking and impulsive decision-making, personality traits that can also get one in trouble" (Greenspan 3). By being too trusting, we have the potential to get ourselves in more situations that will not end in our favor. It is the idea of being too nice or too giving that always results in people getting the short end of a stick.

Finally, there is emotion, the messiest of all. Emotions in any situation can lead us astray and financial scams are no exception. If we let our emotions get the best of us, they will cloud our judgment and cause us to make poor decisions. In addition to Greenspan's theory, emotional psychology has discovered that a key part in our mistakes is our overconfidence. We've all seen on the news people getting scammed out of their investments and people getting their identity stolen unknowingly. We believe those people are gullible, and that we would never make those types of mistakes. With these beliefs in mind, we convince ourselves that our investments are safe. In "On Financial Frauds and Their Causes: Investor Overconfidence," Steven Pressman says, "Adding further credence to these beliefs is the fact that most mutual funds advertise their returns and attempt to attract new investors with their claims of having 'beaten the market'" (415). The two factors go hand in hand. We believe we are safe from financial fraud and the people we invest with give us a false sense of security with great returns which adds to our gullibility.

Aside from Greenspan's theory is our financial knowledge when making investment decisions. We have all heard the classic saying, "don't put all your eggs in one basket," but it is hardly ever followed.

“What went wrong was their rejection of basic bedrock principles of investing—that high returns are leg-shackled to high risks; that you should never put all your eggs in one basket; that you should never invest in anything you cannot understand. They failed to see that no one should hand all their money over to anyone simply because they trust him, or because someone they admire trusts him” (Henriques 358).

Bernard Madoff had set up his affairs and they were all in his favor. He had convinced enough wealthy people to invest with him; to join his club. His investors fell into his trap with their lack of financial knowledge and their desire to make money, while putting in the least amount of effort.

### **Why They Commit The Crime**

After looking internally about how this could have happened to such vast numbers on such a scale, it's time to look at the swindlers. What is it about them that make us wish to partake in their financial schemes? More importantly, why do they commit these crimes? Researcher Frank Perri gives insight as to why they seem so harmless in his article, “White-Collar Criminals: The ‘Kinder, Gentler’ Offender?” Perri uses the term “White-Collar Criminal”, or WCC, to define financial scammers like Bernard Madoff. The term is best defined by sociologist Edwin Sutherland as “a crime committed by a person of respectability and high social status in the course of his occupation” (citation?). Recently, psychologists have begun to research the way these scammers think. There might be a distinct or similar characteristic that these criminals have that is similar to how violent criminals who commit murders get evaluated psychologically.

It's been shown that criminals, such as serial killers, possess an anti-social personality disorder, which is “a persuasive pattern of disregard and violation of the rights of others and a lack of social conscience and conventional morality” (Perri 224). This personality disorder enables them to rationalize or neutralize their behavior, which is why they will commit these crimes. Normally, one would feel

immense guilt after committing any kind of crime, no matter how big or small. However, after financial criminals commit the crime, the guilt is neutralized. “Neutralization paves the way by nullifying internal moral objections, and, regardless of the type of fraud, most offenders seem to seek or justify and/or rationalize their activities” (Perri 223). They find a way to justify why they did it and why it was okay. Their minds go through a completely different thought process.

A key aspect in their thought process is how quickly they can divert the attention elsewhere, and how smooth they are able to change the topic of a conversation. In 2008 when Madoff's scheme was close to collapsing, he had met with the Fairfield Greenwich Investment Group. Suspicious about his consistently high returns, the purpose of this meeting was to get answers from Madoff. Instead of buckling under pressure and confessing, “Madoff starts applying his magic formula: exclusivity, confidence, masterful knowledge. He reminds them once again that he shouldn't even have to submit to these due-diligence quizzes, given how much in demand he is among global investors” (Henriques 200). Just like that, Bernie Madoff turned the argument around to the men of Fairfield Greenwich, shaming them for their lack of respect for such a knowledgeable man. The men were stunned; they did not expect this reaction, so they failed in their mission.

In addition to the arguably psychopathic actions of financial criminals, there is also a physical aspect. When Perri addresses these criminals as “white-collar”, we think of them as hard working heroes in nice suits with a family and so on. This deceives us into thinking they are good people. They can put on an air of exclusive expertise, when in reality those are the people of which we should be most suspicious. When many financial criminals are caught, the punishment is less severe than that of a criminal who robs a store or sells drugs because of the image they portray. A positive and high status image is what helps these swindlers get out of trouble with the law. White-collar crime was extremely downplayed in the eyes of the legal system, until recently.

For many financial criminals, when they are caught committing fraud, it is their first time getting in trouble with the law. “He or she is a first-time offender, middle aged, well educated, trusted employee, and considered a good citizen...This type of offender has been characterized as an accidental fraud offender” (Perri 219). Just by the look of them, a judge is more likely to let them off with a slap on the wrist and told not to do it again, despite the amount of financial damage they have caused. When Madoff was arrested for the exposure of his scheme, it was his first time in trouble with the law. However, due to the amount of damage he caused, he was not let go that easily. In fact, prosecutors really “threw the book at him,” giving him 150 years in prison. Still, when others see this type of behavior, they then think that they can get away with that same type of fraud as well, which is why in the past it happened so frequently and will continue to happen in the future.

#### **Preventative Steps and Possible Solutions**

It can sometimes seem like there is no one who can be trusted with our investments, but recently there have been more possible solutions and preventative steps we can take to protect ourselves from fraud and being scammed out of all of our savings. It starts with rational thinking, and it is modeled on James Rest’s “Model of Ethical Action.” In Pamela Murphy’s article “Psychological Pathways to Fraud,” ethical reasoning starts with four steps. The first step is identification of a situation as an ethical dilemma. By finding something wrong with the investments and/or the swindler at the early stages, one has the opportunity to get out of the situation before too much damage can be done. The second step is to make an ethical judgment, or decide what ought to be done (Murphy 613). The next two steps are intending to act ethically and carrying out the ethical action (Murphy). Thinking ethically is a key part in saving us from a financial scam if one can get past setbacks such as the halo effect, in which one quality of a person is highlighted and gives a skewed positive image of the person, or other overpowering qualities.

The last chapter of Greenspan’s book is rightfully titled, “Becoming Less Gullible.” He addresses the ways that investors can protect themselves. A big factor is keeping oneself out of situations that will make one vulnerable. As mentioned above, being a “yes man” can lead to undesirable outcomes. To avoid situations where targets can’t say no, investors should try to find areas of “self-service, and where salespeople, if there are any, are likely to leave them alone” (Greenspan 170). By keeping oneself out of a location of prime vulnerability, we are able to take care of most business without communicating with pushy people. If one must deal with people who are too pushy in our decision making process, one must find a way to revert the conversation back to the person we’re dealing with. Taking back the conversation is pivotal. “The important thing is to frame your communication in a manner that indicates that you have made a firm decision and have no interest in discussing the matter any further” (Greenspan 177-8). In addition, we need to educate ourselves. “Gullibility is, in part, a failure to tell when something is not true. Or, to put it another way, gullibility occurs when someone believes something that is not true, whether or not it is an intentional lie” (Greenspan 173). It’s important to get all the information and the facts when it comes to decision-making. One must always be a little skeptical when making decisions and having many options to choose from. Taking time when making decisions, especially those that are financial, is crucial.

On a psychological level, there have been advances in uncovering if employees display certain qualities that a white-collar criminal would possess. A Business Integrity Scan (B-Scan) has been created to assess “integrity, attitudes, and judgments of individuals relevant to ethical business practices” (Perri 223). With the help of the B-Scan, businesses can attempt to weave through the potential employees easier by seeing if they possess those negative qualities that could lead them to commit fraud. The hopes are that the B-Scan can be a largely preventative step and we could potentially see less fraud occur in the future.

It can be difficult to look for the good people out there. Every day there is something new and scandalous going on in the financial world. We think we are safe from the scams and schemes and that our investments are in good hands. Criminals such as Bernard Madoff think they can pull off the next financial scam and get away with it, but soon enough something fishy arises and the whole plot collapses quicker than it started. The personality of a swindler makes it hard for us to discover we're being scammed because they deceive us with their appearance, their charisma, and their will to win. They get us with the halo effect and we only see the good in them. We still have to be cautious in the things we do for our finances, we cannot think that we are impervious to scams. It's up to us to protect ourselves from the fraud. Given the power of our deep-seeded emotional brains to sweep away the best of our critical thinking, it won't be easy.

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