Information, trust and the limits of “intelligent accountability” in investment decision making: Insights from the Madoff case

Hervé STOLOWY
HEC School of Management, Paris, France

Richard BAKER
Adelphi University, Garden City, NY, USA

Thomas JEANJEAN
ESSEC Business School, France, Singapore

Martin MESSNER
University of Innsbruck, Austria

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Hervé Stolowy, Richard Baker, Thomas Jeanjean, and Martin Messner

aHEC Paris, France
bAdelphi University, Garden city, NY, USA
cESSEC Business School, France, Singapore
dUniversity of Innsbruck, Austria

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*Corresponding author: e-mail: stolowy@hec.fr.
ABSTRACT
In this paper, we use the investment fraud of Bernard Madoff to inquire into the possibilities and limits of an “intelligent accountability” in the context of financial decision making. Drawing primarily upon data related to U.S. individual investors (interviews and letters), we investigate the role of information and trust in investment decisions. We find that trust played an important role in the Madoff case. We also find that, in face-to-face encounters with the investors, Madoff successfully created a “transfer of accountability” by invoking the existence of institutional-based controls. The written account statements that Madoff sent to investors created an “illusion of transparency” and comforted investors by showing them how well their investments were performing. Our findings suggest that information and different forms of trust may interact to prevent intelligent accountability. Moreover, even if improvements in existing mechanisms of accountability are possible, it is unlikely that these mechanisms will provide investors with sufficient protection against fraud or misbehavior. Our analysis thus suggests that the most effective solution to this problem may involve reliance on some basic rules regarding verification, diversification and self-imposed restrictions against certain types of investments.

RESUME
Dans ce papier, nous étudions la fraude perpétrée par Bernard Madoff pour étudier les possibilités et limites d’une « reddition de comptes (accountability) intelligente » dans la décision d’investissement. En se fondant principalement sur des données liées à des investisseurs individuels américains (entretiens, courriers), nous étudions les différents types d’information, et les formes de confiance, qui ont eu un impact sur la décision d’investissement. Nous trouvons que la confiance a joué un rôle important dans l’affaire Madoff. Nous trouvons également que, dans des rencontres avec les investisseurs, Madoff a réussi à créer un « transfert de reddition de comptes » en invoquant l’existence de contrôles provenant des institutions. En outre, les relevés de comptes écrits que Madoff envoyait aux investisseurs créaient une « illusion de transparence » et les confortaient en leur montrant combien leurs investissements étaient rentables. Nos résultats suggèrent que l’information et les différentes formes de confiance peuvent interagir pour empêcher une « reddition de comptes intelligente ». De plus, même si des améliorations dans les mécanismes de reddition de comptes sont possibles, il est peu probable que ces mécanismes fournissent aux investisseurs une protection suffisante contre la fraude. Notre analyse suggère que la solution la plus efficace à ce problème pourrait être le recours à quelques règles de base concernant la vérification, la diversification et des restrictions concernant certains types d’investissement.
1. Introduction

Economic exchanges rely to a great extent on information provided to and obtained by investors from different sources and channels. Economic theories of financial markets have long recognized the central role of information in animating markets (e.g., Arrow 1963, 1984). Information is at the heart of any contractual relationship. It allows investors to make “informed” investment decisions and to verify whether other contracting parties fulfill their obligations. As such, information is crucial for the realization of any accountability relationship.

Financial decisions, however, also rely on the trust that individual investors have in the functioning of markets. The role of trust in everyday (economic) life is easily overlooked, due to its fundamental and implicit nature (Giddens 1990). Trust is needed because it would be impossible or at least overly costly to obtain a sufficient level of information that would allow us to say that we “have checked it all by ourselves”. Trust in financial markets refers to the expectations that investors have regarding the behavior of other market participants. As Olsen (2008) puts it, “investors’ trust in the expertise and intentions of corporate managers, financial advisors and regulators is the ‘will of the wisp’ that creates and animates what we call the financial marketplace” (p. 2189).

Whilst economic exchanges are usually based on both information and trust, there is a tendency to see trust as the more problematic ingredient in such exchanges. This is because trust implies a status of being “vulnerable to the actions of another party” (Mayer, Davis, and Schoorman 1995, p. 712). Moreover, there may be insufficient monitoring or control mechanisms to prevent damages in the event that the other party fails to perform as expected. This apparent limitation on trust helps to explain increasing calls for greater information and transparency in financial markets. Particularly in the aftermath of corporate scandals, market crashes, and financial crises, calls for greater transparency are widely heard (see, e.g., Kaufmann and Weber 2010). ¹ It is argued that greater transparency would allow market participants to make more “informed” decisions leading to a reduction in damages arising from unexpected events – ranging from simple under-performance to fraudulent activities.

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¹ The Sarbanes-Oxley Act of 2002 was enacted in response to numerous corporate and accounting scandals. It aims to reinforce corporate accountability (Jain and Rezaee 2006).
There are, however, certain critical voices that question whether more transparency can actually lead to an improved marketplace. In early 2009, *The Economist* featured an article arguing that the case for more information was not as clear-cut as it may seem:

“In financial markets, [transparency] is nearly always equated with information disclosure. The trouble is that the information is often incomplete, irrelevant or outright incomprehensible. Subprime-mortgage-backed securities are a case in point. These instruments—whose value remains shrouded in mystery—can have prospectuses of about 500-600 pages, most of which are devoted to intricate legalese. Yet, inexplicably, they do not contain the information about individual loans that is needed to detect default risk” (Anonymous 2009).

This sort of skepticism is also reflected in academic research. Roberts (2009) has suggested that increased information may simply create an “illusion of transparency” (p. 962) rather than actually improving control and accountability. While the belief in the production of additional information suggests that “all that accountability requires is this laying bare or making visible of ‘what is’” (p. 962), the problem with such a view, argues Roberts, is that information may easily become decoupled from the real concerns of practice and turn into a form of impression management or the production of comfort (see also Power 1997). Roberts (2009) associates the illusion of transparency with the rather abstract nature of the information upon which transparency often relies. He contrasts this with an “intelligent” form of accountability which does not rely on distant information but seeks to engage with the details of practice, typically in the form of a “face-to-face encounter, rich with information, in which communication is less easily stage-managed and rhetoric can be constantly compared to actual practice” (p. 966). The idea of an “intelligent accountability” is to seek information *that can be trusted* allowing a genuine accountability relationship to emerge (see also O’Neill 2002).

In this paper, we build upon this line of thinking and extend it by discussing the possibilities and limits of an “intelligent accountability” in the context of financial investment decisions. We investigate empirically how different forms of information and trust influence an investor’s original investment decision as well as his or her subsequent behavior. While we show that information may create an “illusion of transparency” (Roberts 2009), our empirical material also suggests that “intelligent accountability”, as envisaged by Roberts (2009) and O’Neill (2002), may be difficult to realize in financial markets. Intelligent accountability
would require assessing asset management practices in a direct way, possibly through face-to-face interactions between investors and the fund manager. Such contacts are rare in the context of investment decision making because most investors invest “at distance”. Even if there is close contact between the contracting parties, there may be mechanisms that prevent intelligent accountability to be realized.

We derive our findings from an analysis of the investment fraud of Bernard Madoff, which was revealed at the end of 2008. Madoff had for many decades run a wealth management business, Bernard L. Madoff Investment Securities LLC (BMIS), without investing his clients’ money in securities. He created a so-called Ponzi scheme\(^2\), where money from new investors is used to pay interest and dividends to existing ones. We chose to work with the Madoff case primarily because of the considerable amount of attention that it has attracted in the media. The public material available about the case has allowed us to contextualize, and extend, our primary empirical material collected through interviews with individual U.S. investors. The exceptional nature of the Madoff fraud may imply that we are dealing with a case that is unique in terms of the dynamics of information, trust, and accountability in which we are interested. However, we believe that, despite its exceptional aspects, the Madoff fraud helps us to understand some generic mechanisms at work in investment decision making.

Our paper makes several contributions to existing literature. First, we contribute to the literature on accountability (see, e.g., O'Neill 2002; Messner 2009; Roberts 2009) by discussing the possibilities and limits of realizing an “intelligent” form of accountability in financial markets. In particular, we argue that the implementation of “intelligent accountability” requires conditions that are rarely met in the context of financial investments and that, instead of trying to improve accountability, it may be more fruitful to caution investors regarding some basic rules. Second, we illustrate the usefulness of Zucker’s (1986) distinction between characteristics-based, process-based, and institutional-based trust for research in accounting. Prior accounting literature (e.g., Das and Teng 2001; Langfield-Smith and Smith 2003; Emsley and Kidon 2007) has relied on other typologies of trust to explain phenomena (for an exception, see Neu 1991). We believe that Zucker’s typology is useful for accounting research because it pays particular attention to institutional-based trust, which has increased in importance in the last decades (Unerman and O'Dwyer 2004). Finally, our paper

\(^2\) In a Ponzi scheme, existing investors are paid purported returns out of the funds that new investors contribute. “Ponzi schemes tend to collapse when it becomes difficult to recruit new investors or when a large number of investors ask to cash out” (US Securities and Exchange Commission 2010).
contributes to the fraud literature (Healy and Palepu 2003; Unerman and O'Dwyer 2004; Cooper 2008; Cohen, Ding, Lesage, and Stolowy 2010) by offering unique data regarding one of the most spectacular cases of fraud.

The remainder of the paper is organized in the following manner. In the next section, we elaborate on the concepts of information and trust and examine the relationship between them. The third section describes our research design. After providing some background information on the empirical context of our study, in the fourth section, we analyze the interplay of information and trust in the Madoff case. We conclude with a discussion of the concept of intelligent accountability and provide suggestions for future research.

2. Information and trust

When individuals engage in a contractual relationship – such as by forming an organization or exchanging goods or services – the contracting parties have certain expectations regarding the other person’s behavior. For example, in an exchange of goods, there are expectations regarding the quantity and quality of the goods, the venue and time of the exchange, and so forth. There is a certain degree of risk that these expectations may not be fulfilled. Contracting parties will therefore try to obtain information to help them decide whether they should engage in the relationship in the first place and whether to continue the relationship over time.

The accounting literature is well aware of the crucial role of information for decision-making. One stream of literature investigates, for example, how experimental subjects react in terms of investment decisions or other types of decisions when confronted with additional information (Maines and McDaniel 2000; Libby, Bloomfield, and Nelson 2002; Koonce, McAnally, and Mercer 2005; Libby, Hun-Tong, and Hunton 2006; Maines, Salamon, and Sprinkle 2006). Another stream of research develops analytical models focusing on the optimal type of information needed under the assumption that the behavior of the agent is not directly observable (Verrecchia 1990a, 1990b; Gigler 1994) More recently, there has also been empirical work on the value of information exchanged in face-to-face relationships in financial markets (Barker 1998; Roberts, Sanderson, Barker, and Hendry 2006).

Decisions are rarely made in the context of complete information and certainty. In everyday life, many things are simply taken for granted. Information is actively sought, but it can only reduce part of the uncertainty in the environment. The remaining gap between information and uncertainty is often filled through trust. As Tomkins (2001) says, “trust implies adopting a belief without full information” (p. 165). For example, when making
financial investments, investors may choose not to obtain additional information about the companies in which their investment advisor places their money, because they trust that the advisor will make the right decisions. While trust is thus “an alternative uncertainty absorption mechanism to increased information” (Tomkins 2001, p. 165-166), trust also relies on information. There must be some reason for trust to develop, and this reason is linked to information about past experience. Zucker (1986) suggests that trust may be based on three types of information: information about a person and his or her characteristics, such as family background or ethnicity; information about past exchanges with that person such as reputation; or information about certain institutions and their functioning (reliance on the power of institutions). Accordingly, she distinguishes between characteristic-based trust, process-based trust, and institutional-based trust.3

Some scholars have pointed out that through time, institutional-based trust has increased in importance (Zucker 1986; Giddens 1990; Beck 1992). With increased globalization and time-space distanciation (Giddens 1990), trust has shifted from trust in specific people and their activities into a more diffuse trust in institutions or “expert systems” (ibid.). For example, in the specific context of stock exchanges, Neu (1991) examined the mechanisms involved in new share issuances and concluded that “institutional-based” trust has become increasingly important for the effective functioning of new share issuances as compared with “process-based” and “characteristic-based” trust.

The accounting literature has looked at the role of trust in organizational decision-making, and particularly in the context of inter-organizational relationships (van der Meer-Kooistra and Vosselman 2000; Free 2007; Vélez et al. 2008). However, little focus has been placed on institutional-based trust. The accounting literature has also looked at the crucial role of trust in financial markets (Unerman and O’Dwyer 2004), but a detailed empirical examination of the impact of trust and its interplay with information in financial decision-making is missing.

3. Research design

The research design employed in this study involves a qualitative approach based upon interviews with individuals who invested with Madoff and analysis of letters written by other

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3 There are other definitions and categorizations of trust that have been applied in the accounting and organization literatures (Moorman, Deshpandé, and Zaltman 1993; Mayer et al. 1995, p. 712; Nooteboom 1996; Rousseau, Sitkin, Burt, and Camerer 1998; Das and Teng 2001; Neves and Caetano 2006, p. 353; Emsley and Kidon 2007, p. 830; Patzelt and Shepherd 2008; Vélez, Sánchez, and Álvarez-Dardet 2008; Vosselman and Meer-Kooistra 2009, p. 269). In this paper, we apply Zucker’s typology as it serves particularly well to illuminate the dynamics of trust in the Madoff case.
individuals who also invested with Madoff. A qualitative approach is appropriate for our research focus for at least two reasons. First, in order to understand the dynamics of investment decisions, it is important to consider actors’ own beliefs and perceptions about the situation and its context, rather than an outsiders’ description. For example, in order to understand why an investor does or does not invest money in a fund, it is not relevant whether the fund is or is not well managed according to some objective standards; what counts is whether the investor believes the fund is well-managed or not. Qualitative methods are helpful in uncovering such beliefs. Previous accounting research has adopted this methodology for similar empirical settings (e.g., Gendron and Spira 2009). Second, the particular case of investment fraud constitutes a “delicate” topic to investigate. Given the enormous financial losses and personal setbacks that many of the investors suffered, it was important to relate to them with empathy, which is arguably easier in a personal conversation, even by telephone or voice over the internet, than through impersonal means such as questionnaires.

In order to identify persons who invested with Madoff, we consulted several sources. In February 2009, the U.S. Federal bankruptcy court released a full list of Madoff’s clients (available through the Internet). This list is 162 pages long and mentions approximately 14,000 investors. Some of the investors are listed multiple times, presumably because they had more than one account with Madoff. According to Sander (2009, p. 229), the actual number of individuals who invested with Madoff was 11,374, across forty-four U.S. states and forty countries, with the majority concentrated in the New York and Florida areas.

More detailed information regarding some of the investors was obtained from letters sent by the investors in support of Madoff’s sentencing. In June 2009, Federal prosecutors in New York City filed statements from 113 alleged victims of Bernard Madoff’s fraud with the U.S. District Court Judge. The filing was made prior to Madoff’s sentencing on June 29, 2009. These letters, or “victim-impact statements”, ranged from one paragraph to several pages, and they contain personal stories of the investors and their losses. The 113 statements can be subdivided into two categories: 65 “direct” investors (including 8 “direct” investors who

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5 These statements are available from many sources (e.g., http://www.cnbc.com/id/31375911/Read_Them_Here_Madoff_Case_Victim_Statements) (last retrieved: August 30, 2011). A few of these statements have been written by former employees of Madoff’s legitimate activity.
request to speak at the sentencing) and 48 “indirect” investors who ask for the right to be considered in the same way as direct investors.

We decided to examine these 113 statements for several reasons. First, we thought that the investors who narrated personal stories in written form would be the ones most willing to be interviewed. Second, reading the letters provided us with some background information regarding the investors, such as whether they had invested directly or indirectly in the Madoff funds. This information proved helpful in preparing our interviews.

Among the 113 statements, 45 included an e-mail address while 12 included only a postal address or telephone number. Accordingly, we sent out 45 e-mails and 12 letters asking for an interview: 55 contacts were made with direct investors (out of 65) and two e-mails were sent to indirect investors: one who represented 46 other indirect investors in a “Ponzi victims coalition” and one who contacted the Judge directly. Eleven investors (10 following e-mails and one after having received a letter) accepted an invitation to have a conversation with us. Each interview was made by telephone or voice over internet following the interview guide shown in Appendix 1. The interviews were recorded with the approval of the interviewees and were subsequently transcribed. Given the stressful situation for most of our interviewees, we kept the conversations rather short. Among the eleven investors, nine were direct investors in Madoff’s funds and two (Investors 6 and 7) invested indirectly through a feeder fund.

In addition to the interviews, we analyzed in detail the statements written by the 65 direct investors and found, in 26 instances, some textual material related to our research topic and corresponding to our interview guide. Among these 26 statements, eight were written by investors that we interviewed. Consequently, to avoid double counting, we removed these statements from our data set. Our resulting sample includes 29 investors: 11 interviews and 18 statements from non-interviewed investors.

We complemented the interviews and analyzed statements with several other sources of data that allowed us to obtain a better understanding of the fraud and of the relationship between Madoff’s company and the investors. First, we conducted two further interviews: one with the CFO of an organization that is close to the Jewish community, and which was mentioned in the media because it chose not to invest with Madoff (Strober and Strober 2009, p. 42)\(^6\) and one with the CEO of a company specializing in defending the interests of minority shareholders, who represents several of Madoff’s investors. In addition to our interviews, we also consulted publicly available primary materials, such as videos of victims published on

\(^6\) In the rest of this article, quotations from this interview will be made by reference to “non-investor 1”.

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the Internet. Finally, we read several books (Arvedlund 2009; Kirtzman 2009; LeBor 2009; Oppenheimer 2009; Ross 2009; Sander 2009; Strober and Strober 2009; Weinstein 2009; Henriques 2011) and press articles (see, e.g., Seal 2009) that addressed the Madoff fraud or books dealing with the Ponzi scheme (Dunn 1975; Walsh 1998; Zuckoff 2006).

Two main questions guided our interviews: What led people to invest with Madoff and how did this impact their behavior prior to the investment decision? What kind of information did investors receive during the investment period and how did this influence their behavior along the way?

Data analysis was carried out by reading through the interview transcripts and the impact statements and by moving back and forth between data and theory until we were able to identify patterns that we thought provided interesting theoretical insights (Ahrens and Chapman 2006). In the following sections, we present these insights, organized around the themes of information and trust. Before doing so, we provide some summary background about the Madoff fraud.

4. The investment fraud of Bernard Madoff

Bernard Madoff, born and raised in New York City, founded Bernard L. Madoff Investment Securities LLC in 1960. He remained chairman of the board of directors of this firm until his arrest on December 11, 2008 (Voreacos and Glovin 2008). As his business grew, Madoff was eventually able to purchase numerous properties including houses, apartments and boats in locations around the world; however, he was said to have lived in a relatively unostentatious manner (Arvedlund 2009, p. 13; Strober and Strober 2009, p. 23). According to a government filing in March 2009, Madoff and his wife had a net worth of about $126 million, plus an estimated $700 million for the value of his business interest in Bernard L. Madoff Investment Securities LLC (McCool and Honan 2009).

One of the aspects of Madoff’s demeanor, which may have allowed him to perpetuate a fraudulent scheme for such a long time, was that he was active in his community as both a philanthropist and as a contributor and participant to civic organizations. He served on the board of directors of many charitable institutions — several of which entrusted his firm with investing their endowments. He and his wife also gave money to political parties, with the major portion going to the Democratic Party of the United States. Madoff was also active in

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8 Interviewed investors are referred to as “Investor 1 to 11” and the other investors are referred to as “Investor 12 to 29”.

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the National Association of Securities Dealers (NASD), a self-regulatory securities industry organization. He served as the Chairman of the Board of Directors and as a member of the Board of Governors of the NASD. Madoff was also a member of the Board of Directors of the Securities Industry Association, an industry association for securities firms.

On December 10, 2008, Madoff’s sons informed federal authorities that their father confessed to them that the investment management part of his firm was fraudulent, and quoted him as saying it was “one big lie” (Appelbaum, Hilzenrath, and Paley 2008; Henriques 2011). The following day, FBI agents arrested Madoff and charged him with securities fraud. In March 2009, he pleaded guilty in the United States federal district court in New York City to eleven federal crimes, and he admitted that his wealth management business was a Ponzi scheme.

Bernard Madoff perpetuated his fraudulent scheme by never making any trades for his investors (Ross 2009, p. 185). On a daily basis, Frank DiPascali, Madoff’s chief financial officer, kept track of the closing prices of the Standard & Poor’s 100. Then, on a regular basis, DiPascali and Madoff would pick the stocks that had done well and create false trading records for their “basket of stocks” (Ross 2009, p. 74). One of his employees was in charge of producing statements reflecting thousands of trades that were supposedly being executed for Madoff’s investment clients (Ross 2009, p. 73).

Madoff confessed that he had begun his fraudulent financial scheme in the early 1990s. However, federal investigators believe that the fraud began as early as the 1980s (Ross 2009, p. 205; Safer 2009). While the amounts missing from client accounts is alleged to be as much as $65 billion, the court appointed trustee has estimated the losses to investors were actually about $18 billion (Henriques 2009). On June 29, 2009, Madoff was sentenced to 150 years in prison (Frank, Efrati, Lucchetti, and Bray 2009).

The collapse of Madoff’s investment company and the subsequent freezing of his assets and those of his firm affected businesses, charities, and foundations around the world. In table 1, we present a summarized chronology of the main events of the Madoff case.

Insert Table 1 About Here

5. Deciding to invest: information and trust

When asked about how they got into contact with Madoff’s investment fund, several of our interviewees referred to other persons, such as relatives, friends, or business partners, who recommended investing in Madoff securities:
“I had a partner on the account, and my partner’s brothers worked for a firm on Long Island, in New York, who had their retirement plans with Madoff. And we heard about it through that connection. [My partner’s] brother worked for that company and was telling us how pleased he was with his profit-sharing plan with the company” (Investor 2, interview).

“My mother was a direct investor. […] I originally went in on that account to help her, because I am a professional. […] Friends recommended that she go to this” (Investor 9, interview).

“I had an older brother […] He was a manufacturer, and he put most of his money with Madoff, based on the information he had […] He sent me a clipping or two from the Wall Street Journal, and that was impressive. So, it sounded good to me” (Investor 11, interview).

“Our accountant, Paul (…) is/was a friend and investor with him [Madoff]. My father saw that Paul was doing well and decided to invest some money with him” (Investor 21, impact statement).

“I was looking for a new financial advisor, because the one I had had for a few years was retiring, and I spoke to a businessman, a friend of mine in New York, who told me that he had two advisors that he used. One was […] and another one was Bernard Madoff, whom I had never heard of. I had a lot of confidence in my friend” (Investor 4, interview).

As implied in the last quote from investor 4, acting upon recommendations from others requires a certain level of confidence or trust that the advice is sound and that the investment will be profitable. Zucker’s (1986) distinction between characteristic-based, process-based, and institutional-based trust provides a useful distinction and categorization to understand the kinds of trust dynamics that were at work in the Madoff case.

In the case of characteristic-based trust, what counts are a person’s characteristics, such as family background or ethnicity. If another person shares some of these characteristics, then this creates a common background which reduces the perceived need to negotiate the terms of exchange, or to inquire into the other person’s credibility (Zucker 1986, p. 61). In the case of Madoff, several commentators emphasized how Madoff exploited his affinities with certain groups or communities. It is well-known, for example, that Madoff used his links with the Jewish community to facilitate his fraudulent scheme (Sander 2009, p. 170; Strober and
Likewise, he had affinities with other groups of significant investors such as: motion picture artists, some of them funneled by the Brighton Company, headed by Stanley Chais (e.g., acting couple Kevin Bacon and Kyra Sedgwick, director Steven Spielberg, DreamWorks executive Jeffrey Katzenberg, screenwriter Eric Roth) (Ross 2009, p. 162, 176); the “French connection” through Access International and Thierry de la Villehuchet⁹; and the “Latin connection” via Banco Santander (Sander 2009, p. 83). Fairfax (2001, p. 70) refers to the exploitation of such shared characteristics as “affinity fraud”. Affinity frauds prey on groups – religious, ethnic, professional, or other like-minded organizations – in order to sell some kind of investment or membership in something (Sander 2009, p. 73). Among our interviewees and the analyzed statements, only one referred to affinity with Madoff:

“My Dad did not want to even discuss it. He was so committed to Madoff. And a lot of this had to do, again, the relationship... And he had only met Bernie and/or Peter one time. But the tie to the Jewish community, Jewish philanthropy, Jewish charities and the fact that his friends were also successfully working with Madoff; there was no other place for us to put the money” (Investor 8, interview).

However, even if there was no direct affinity between an investor and Madoff, characteristics-based trust may have been at work. Potential investors’ trust in their relatives or friends, with whom they share certain expectations, can create characteristics-based trust “second-hand”. This seems to have been the case for investor 4 who explains that he “had a lot of confidence in [his] friend”.

Personal characteristics do not seem to have been the most important trust-producing mechanisms for our interviewees. A second form of trust was more visible in our interviews. Zucker refers to this as process-based trust which she defines as trust “tied to past or expected exchange such as in reputation or gift-exchange” (Zucker 1986, p. 53-54). What counts here is the fact that there is some past track record that fuels one’s expectations about the future. The following quotes exemplify this kind of trust:

“As a matter of fact, I went to the New York Public Library and I investigated as best I could [...] I do recall there being an article in the New York Times or the Wall Street Journal, saying the man was a wizard. No one

⁹ The manager of this $1.4billion, who committed suicide on December 23, 2008.
knew exactly how he did what he did, but he was successful and nobody cared” (Investor 2, interview).

“We knew [Madoff] had headed up, or started, I think, […] the Cincinnati Stock Exchange. He was a consultant to the SEC” (Investor 9, interview).

“Madoff […] was also formerly president of NASDAQ and was very highly regarded in Wall Street. And he [the brother of the investor] couldn’t find out anything negative about him” (Investor 11, interview).

“I thought I had invested … with a highly credentialed Wall Street expert” (Investor 27, impact statement).

“Madoff victims … had the misfortune to believe in a powerful Wall Street insider” (Investor 14, impact statement).

“My husband originally knew Mr. Saul Alpern, father in law of Mr Madoff, who was a very nice honest accountant (…) When he mentioned (…) that his son in law was in the financial area doing very well for his clients, [we] decided to invest” (Investor 25, impact statement).

In the first quote, trust is generated through knowledge about the past success of Madoff; in the second through fifth quotes, it is Madoff’s participation in prestigious institutions or reputation that creates expectations concerning his investment expertise. As pointed out by Zucker (1986), a record of prior exchanges is often “obtained second-hand” (p. 60). When the investors refer to how their friends or relatives made money with Madoff, they build upon second-hand experiences. When investor 2, in the quotation above, explains “how pleased” his partner’s brother was with his investment with Madoff, or when investor 25 mentions that Madoff was “doing well for his clients”, they allude to this type of trust-producing mechanism, where past performance is taken as a predictor for future performance. Process-based trust may come about in an even more indirect way. When some of our interviewees referred to the financial expertise of their relatives and friends, they formed their expectations on the basis of prior exchanges rather than those with Madoff:

“First, in about 1985, through a friend of my brother’s, who […] had been very successful with finances, and my brother was speaking well of him and he had a good fund […], and I did invest” (Investor 5, interview).
Someone who was “very successful with finances” can be expected to make the right investment decisions in the future. Such process-based trust is hardly sufficient in and of itself to motivate an investment. The investment must also appear to be attractive to the potential investor. Someone who is very trustworthy may recommend an investment with a safe return of, say, 3% per annum, but this will not motivate an investor who looks for higher returns. In the case of Madoff, it appears that many investors were attracted by the stability of returns that Madoff’s investments had provided in the past rather than looking for a very high rate of return. As one of our interviewees elaborates:

“A lifelong friend of mine, who is one of America’s wealthiest individuals, suggested that I invest with him, because I was looking to put a chunk of money in what I considered a relatively safe and consistent return, unlike the market where you can go up 20 percent and down 20 percent […]” (Investor 3, interview).

Being “one of America’s wealthiest individuals” implies that this friend would be able to identify a good investment. Thus, there is process-based trust at work here. At the same time, the investor was apparently attracted by what he perceived to be “relatively safe and consistent returns”. Another investor responds in a similar vein:

“Now, my Dad and his brother were very, very, very conservative investors. […] Somewhere along the line, probably at one of the country clubs, during a golf game, or whatever, one of the friends said: ‘I met this guy Bernie Madoff, and he has a fund that has virtually guaranteed returns, and he has already got a track record’” (Investor 8, interview).

It was not extraordinarily high returns that the “conservative investors” were looking for; rather it was the idea of “virtually guaranteed returns” that were higher than those of other, low-risk investments.

The presence of characteristics-based and process-based trust reduces the perceived need to obtain additional information regarding the investment, which highlights the substitution effect of trust. This does not mean, of course, that there were no efforts to learn about Madoff and his company. Some of our interviewees consulted publicly available material prior to investing with Madoff. Their testimonies reveal another source of trust which they ultimately relied upon:
“There was not a great deal of information available on him [Bernard Madoff], but we did know that the SEC, the Securities and Exchange Commission here, did give him a clean Bill of Health after being investigated. And we decided that was good enough for us. We are not sophisticated investors” (Investor 2, interview).

“I would say that I did not do the kind of due diligence one might have done if less sophisticated people were not invested in him. I did not look and see who the accountant was. [...] I would have assumed that something that had billions of dollars invested in it was reviewed by the SEC” (Investor 3, interview).

“He [a friend of the investor] told me that he had talked to the people at the SEC and they told him that everything they knew about Mr. Madoff was satisfactory” (Investor 4, interview).

“Madoff was given a green light by the SEC” (Investor 11, interview).

“Hearing from the SEC that he was a safe broker we thought we were OK with leaving our money with him” (Investor 12, impact statement).

“[Madoff] was repeatedly investigated and given a clean bill of health by a government watchdog agency named the SEC” (Investor 14, impact statement).

In all six of these quotes, reference was made to the SEC and its role in monitoring the activities of Madoff’s firm. It is apparent from the quotes that the investors were reassured by Madoff’s claim that he had been investigated by the SEC and that he had received “a clean bill of health”. However, a report issued by the SEC (US Securities and Exchange Commission 2009, p. 6) found that there had been no thorough examination of Madoff. What appears to be at work here is what Zucker (1986) calls “institutional-based trust”. People rely on the power of institutions, such as laws and regulations, certificates, professions, or educational systems, to ensure a proper functioning of social or economic exchanges. The existence of these institutions produces comfort and reduces the perceived need to personally monitor or control a given exchange process.

Through benefit of hindsight we know that the investors’ trust in the SEC was not warranted; despite several warnings to the SEC, a complete examination of Madoff’s activities was not undertaken by the SEC, and in fact since Madoff’s arrest, the SEC has been
criticized for its lack of investigative diligence. Concerns about Madoff’s operations began as early as 1999, when a financial analyst named Harry Markopolos told the SEC that he believed it was impossible to achieve the gains Madoff claimed to deliver. Markopolos was ignored by the SEC throughout the 2000 to 2008 time period. He has since published a book about the efforts he made to alert the SEC (Markopolos 2010). The SEC’s Inspector General, H. David Kotz, has revealed that since 1992, the SEC received six substantive complaints raising significant red flags about Madoff and conducted two investigations and three examinations related to Madoff’s investment advisory business, with none of them leading to discovery of the fraud. In fact, Madoff could have been caught several times, and especially in 2006, but the investigators never asked the right questions (US Securities and Exchange Commission 2009). As Kotz concludes, “despite numerous credible and detailed complaints, the SEC never properly examined or investigated Madoff’s trading practices and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme. Had these efforts been made with appropriate follow-up at any time beginning in June of 1992 until December 2008, the SEC could have uncovered the Ponzi scheme well before Madoff confessed” (US Securities and Exchange Commission 2009, p. 22). Investors learned about these failures only in retrospect:

“You know, I seem to remember that – and I guess that was in the early 90s – there was some talk of Madoff being investigated by the SEC. But my memory is, my Dad checked it out, and now, we know in retrospect, that if there was an investigation, it took about ten minutes, and they found no issues, and that was the end of it” (Investor 8, interview).

“I was aware that Madoff was investigated by the SEC on several occasions, and subsequently, no indiscretions were found. I felt secure by the SEC’s findings and that my investments were SAFE” (Investor 17, impact statement).

“I continued to feel very secure despite a few blips on the radar, which were immediately cleared up by a statement made by the SEC confirming that Mr. Madoff was still the gold standard of Wall Street”. (Investor 19, impact statement).

The above discussion suggests that different forms of trust impacted the investors’ decision to put their money into Madoff’s fund.
6. Information and the “illusion of transparency”

In light of the above discussion, one may wonder whether increased information can lead to a breakdown of trust rather than a strengthening of it. This would be the case if the information obtained raised doubt about the quality or seriousness of the investment. In particular, information that is obtained “first-hand” by the investors themselves may have such an effect. From our interviews, we learned about two types of such first-hand information: face-to-face encounters with Madoff and information received through the regularly sent account statements. We now turn to discuss how these two types of information impacted investors’ beliefs about their investments.

Encountering Madoff

Prior literature suggests that face-to-face contact offers the possibility for a more intimate social relationship in which the contracting party can be subject to increased scrutiny (Roberts 1991; Shearer 2002; Roberts et al. 2006). In face-to-face encounters, the exchange of information takes on a more “socializing” form that allows for both stronger elaboration of one’s own positions and a better understanding of the other person’s perspectives (Roberts 1991). It would thus seem that information obtained first-hand through such meetings will have a particularly important impact on investors’ decisions.

Most investors did not meet Madoff in person, but some of them did. It is instructive to examine their accounts in terms of how such encounters developed. Among our interviewees, one investor narrated his encounter with Madoff. We quote his narrative at some length here, because of its illuminating nature:

I met with Madoff... I met with one of his salespeople, or advisors, I do not remember the exact word, and I had a meeting with him, and he said to me: “Come on, let us go meet Bernie now.” So, he took me into Mr. Madoff’s office, and he was sitting behind a big desk, very imposing, and the first thing he said to me was: “You know, we need a minimum of a million dollars for you to get into the fund.” And at the time, I had the money, I said: “I am prepared to do that.” And then, he started asking me a lot of questions. And I said to him: “It is a very funny thing. I am investing a million dollars with you and you are asking me the questions. Don’t you think I should be asking you the questions?” At that point, he said to me: “You do not have to ask me any questions. We have been interviewed and examined many, many times by the American Securities and Exchange Commission, and we have
got nothing but a clean Bill of Health from them, and everything that we do has been supervised and inspected, and we are very, very regimented, and there is no problem with us. You can just check with the Securities and Exchange Commission” (Investor 1, interview).

This quote reflects the different strategies that Madoff used to deflect investors’ efforts towards obtaining more information. The encounter starts when the potential investor suggests that it should be investor who asks the questions, rather than Madoff. The first strategy employed by Madoff was to point to the regulatory role played by the SEC. In so doing, he invokes the power of institutional-based trust, emphasizing again the substitution effect of trust. The beginning of the quote also reveals a complementary mechanism at work. When Madoff starts the conversation by pointing out that one million dollars is required to invest, he creates the image of an exclusive investment club – one that is only open to selected individuals. This line of argumentation is continued as the conversation develops, as we see from the rest of the quote:

Then, he said to me: “But I am very sorry, the fund is closed, and we cannot take you in.” And I said: “Okay, thank you very much.” And I left. I called my accountant and I said to him: “You know, I met with Mr. Madoff, and the fund is closed, but the funny thing was, he was asking me the questions and I should have been asking him the questions.” And he said to me, he just kept referring me back to the Securities and Exchange Commission. And my accountant said to me: “You know, he says, they have been inspected many times by the Securities and Exchange Commission and they have a clean Bill of Health and the government has found no improprieties and they are a very legitimate company.” The next day afternoon, I received a call from the gentleman whom I originally met, who took me in to see Mr. Madoff. And he said to me: “You know, I spoke to Mr. Madoff and you are a very nice fellow, and bla-bla-bla, and we will put you in the fund. We will get you in.” Like they were doing me a favor. I found out later, that was their modus operandi with many people. They declined them, and then, they did them a favor by taking them back in, and I think they have done that many times” (Investor 1, interview).

The implication that the investor would be allowed into an exclusive club is increased by Madoff first rejecting the request to invest. Only later is Madoff doing the investor a “favor” by eventually allowing him to put money into the fund.
“The whole deal with Bernie Madoff was, you felt you are lucky to be in a club, so to speak, to be invested with him. My friends [said], well, can’t you get me in, can’t you get me in?” (Investor 10, interview).

The following quote illustrates one strategy of Madoff for not answering questions.

“Bernie had several stipulations. He would invest Hadassah’s money but would be unavailable to answer questions from anyone on our financial advisory board. When I asked him why, he told me the investment advisory side of his company was very small and he implied that he was doing this as an accommodation and didn’t want to be bothered by people asking him a lot of questions” (Weinstein 2009, p. 40).

In addition, Madoff’s efforts to limit the information provided to investors was explained on the basis that he had developed an investment strategy that he needed to keep secret in order to continue offering the extra returns that investors were looking for. While none of our interviewees commented on this point, quotes from the secondary literature point in this direction:

“The fact that he refused to reveal the secrets of his operation only encourage these investors to believe that of all the extant investment advisers, he and he alone possessed the right stuff” [quotation from an interview] (Strober and Strober 2009, p. 152).

“I asked Madoff how he was able to accomplish his amazing returns. ‘I can’t go into it in great detail. It’s a proprietary strategy’” (Arvedlund 2009, p. 7).

By insisting on the proprietary nature of his investment strategy, Madoff managed to become “unaccountable” to his investors regarding the details of his strategy. This is not surprising given that Madoff was regarded as an “expert” or even “genius” who managed to outperform the market precisely because he acted in a different way. In his discussion of the “limits of accountability”, Messner (2009) observes that successful managers or entrepreneurs are often praised for breaking the rules and acting contrary to conventional wisdom.10 If such a practice is accepted – which is often the case as long as it proves to be successful, – then it is difficult to apply the same accountability standards to the details of such actions as in other

10 As Cohen et al. (2010) note, it appears that several managers of fraudulent firms received praise and admiration from the press.
cases. The designation as an expert or a genius implies that some level of unaccountability must be accepted, because it is understood that experts or geniuses cannot simply “explain” what they do – otherwise, everyone could imitate them.

Finally, Madoff was known for his “soft personality” which he used to reassure investors, as shown in the following quote:

“He [Madoff] put his arm around my shoulder and assured me that my money was safe and I should not worry. I have to admit that I was not sophisticated in investing or finance and I trusted this kindly man” (Investor 19, impact statement).

We observed four mechanisms at work in investors’ personal encounters with Madoff – a reference to institutions that provided assurance; the exclusivity granted to investors; Madoff’s status as an expert; and Madoff’s personality. These mechanisms complemented each other in ensuring investors’ trust that, despite a low level of information, Madoff was acting in their best interest.

**Receiving statements**

While the above empirical evidence suggests that Madoff skillfully avoided providing detailed explanations about his trading strategies, this does not mean that investors were given no information at all. In fact, providing no information would probably have created skepticism among investors as to where their money really was going. Madoff’s strategy was to provide investors with a form of written information that would give them little reason to question the credibility of his operations.\(^\text{11}\) From our interviewees, we learn that they received regular statements concerning their investments:\(^\text{12}\)

“I received a very, very detailed monthly statement, every month without fail. The statement showed purchases of stock. The purchase showed selling of stock. The statement showed purchases of United States Treasury Bills. And some of them even had numbers. So, you know, you thought you were really getting the right thing. And every month I looked at my statement, and I said: “Oh, look how much money I made this month.” You know? And the

\(^{11}\) It has long been recognized that financial reporting influences the decisions of external parties interested in gauging organizational performance (Covaleski, Dirsmith, and White 1987).

\(^{12}\) Two investors agreed to send us a copy of their statements: one is dated from 1997 and the other from 2008. Both are identical in terms of format. We provide in Appendix 2 an excerpt from one statement. Private information concerning the investor has been removed.
money just kept coming in on the statements. And because of the statements, I kept thinking how much money I was making at Madoff’s, which really did not happen” (Investor 1, interview).

“Every month I received paper statements from Madoff on both accounts” (Investor 17, impact statement).

These statements apparently provided comfort to the investors because they showed, in a very detailed way, how much money was invested and earned. The importance of the statements is recalled by Ron Stein, President of the Network for Investor Action & Protection Congress, who, in a testimony\(^\text{13}\), explained that the U.S. Congress wanted the Securities Investor Protection Act (SIPA) of 1970 to facilitate a change in the securities system to eliminate a problem that had brought Wall Street to its knees because of back office problems that threatened the U.S. capital markets and economy. “The change was that, instead of obtaining physical delivery of their securities, the investors would leave them in street name at their brokerages (which could use the securities in various ways to make money). The investors would then rely on statements and confirmations received from brokers to evidence the investors’ holdings”.

The fact that there were no actual transactions behind the statements was not visible to the investors. The statements appeared as if they were real for different reasons. First, as noted by several of our interviewees, the statements they received were similar or almost identical to those sent by other institutions. There was no apparent difference in Madoff’s statements that would have caused investors to become suspicious:

“I received regular information, like I would from any other brokerage firm: monthly statements, quarterly statements, a year end statement, the whole thing. Everything seemed very, very legitimate. […] And every time there was supposedly a sale or a purchase, I received a statement accordingly. You know, I had been dealing with brokerage firms for many years and everything was identical” (Investor 4, interview).

“The statements looked just like what you would get from Merrill Lynch, or from Shearson, or very similar to what I get today from Fidelity on a retirement account, a small retirement account” (Investor 8, interview).

A second point worth mentioning is that the statements contained names and stock prices of well-known companies, companies that the investors were familiar with. This reference to real companies reinforced the perceived legitimacy of the statements:

“Monthly statements indicated that all of the investments were in the Fortune 500 companies; all very, very, very big names” (Investor 8, interview).

Third, the statements had the appearance of security, as illustrated by the following quote:

“We all knew that there is risk associated with the stock market but our statements showed [that] we were diversified” (Investor 21, impact statement).

Fourth, the statements sent by BMIS appeared to be real because they could be exchanged with other parties, most notably tax authorities, who would provide another external validation regarding the truthfulness of the statements:

“Regularly, we would get a monthly statement from him […] And once a year, we would get a summary, a one page summary of what percentage growth there was, and I used […] those figures […] for tax purposes. […] The forms were completely consistent and did not look odd or strange at all” (Investor 5, interview).

“At the end of the year, [you got] all the proper tax information that you needed to file your taxes, because this was a direct investment” (Investor 9, interview).

The production of statements similar to regular bank statements, exchangeable with third parties, and linked to other institutions (such shares in well-known companies) helped to create an impression of normality. Whether the statements were “real” in the sense of representing actual trades was difficult for an investor to see. Some of the investors tried to conduct “reality checks” by looking at whether the stock prices indicated on the statements corresponded to those in the newspapers or whether the total sums were calculated correctly:

“My husband […] periodically – especially, when he started to put more money in – [...] checked that the stocks on the days that we supposedly purchased them, were purchased at that price; that the dividends came through on the dates stated. [Madoff] had a very elaborate scam” (Investor 9,
interview). “I used to work in the computer business and I understand bookkeeping; everything was totaled to the penny” [quotation] (Strober and Strober 2009, p. 109).

Some other investors performed some due diligence:

“The monthly statements we received were reviewed and logged in our own version of due diligence” (Investor 28, impact statement).

While these reality tests might have created comfort, they did not allow the investors to judge whether the statements were “true” in the sense of corresponding to an underlying reality of actual trades. Madoff was making sure that there was an *ex post* correspondence between the information on the statements and publicly available information:

“Madoff or his lieutenants were checking the stock returns from previous days and weeks and instructing the clerks to enter transactions that were based on old results. The computer system would apply the same formula to each client’s account, the only difference being the number of shares each of them owned” (Kirtzman 2009, p. 137).

All that investors could check was whether the statements were similar in form to statements issued by other institutions and whether the information regarding stock prices was correct. What they could not do was to “see through” the statements and compare them with some real-world actions to which the statements should correspond. Even when supposedly “actual operations” of BMIS were observed, it was impossible to distinguish between appearance and fact:

“He [Madoff] impressed me very much, as he did everyone else, and there were banks of computers and people running all over the place. I thought this had to be legitimate” [quotation] (Strober and Strober 2009, p. 131).

In light of this, one could argue that the “reality checks” carried out by the investors were simply not elaborate enough. When trying to see whether statements were telling the truth or not, investors only scratched the surface rather than inquiring in depth into what was or was not underneath the statements. Taking such a view, however, implies assuming that it is feasible to distinguish between true and false representations of reality. The problem with this is that representations, in general, are usually regarded as real not because they are successfully compared with some underlying real event or action; instead, whether they are
taken for real or not depends on how they compare to other representations that one has access to. For example, when a newspaper writes about an event that apparently has happened, most people can compare this representation only to what other media say about the event, since in the majority of cases, people will not have directly experienced the event in question. When different representations refer to each other, they create a web of cross-references which can gain credibility independently from any underlying reality. Baudrillard (1981, 1994) refers to the extreme extension of this idea as a state of “hyperreality”: a world in which it is no longer possible to distinguish between true and false representations, because there is nothing but the representations and no underlying reality to which these representations can be compared (see also Poster 1988)\textsuperscript{14}. Several accounting scholars have taken up this idea and have suggested that accounting representations can only be judged as true or false relative to other accounting representations, rather than in relation to some underlying reality (McGoun 1997; Macintosh, Shearer, Thornton, and Welker 2000; Graham 2008). Macintosh et al. (2000), for example, refer to share market prices as representations of the intrinsic value of a firm, and suggest that the idea that “investors can ‘see through’ accounting numbers to discern true market value is no longer sustainable” (p. 31).

In the case of Madoff, the representation was, objectively, wrong. The only thing the investors could do was to compare the representations they received with other representations. This did not help them to detect the fraud, because the representations seemed to correspond with each other. The statements received from Madoff appeared to be normal, because they were similar to the other types of information they were regularly confronted with.\textsuperscript{15}

7. Discussion

Information and trust

Our inquiry into the investment fraud of Bernard Madoff allows us to explore the interplay between information and trust in financial decision making. In our empirical analysis, we distinguish between an investor’s initial decision to invest with Madoff and their decision to maintain the investment or even to re-invest money later on. Figure 1 is organized around

\textsuperscript{14} Eco (1990) refers to the same concept using the expression “authentic fake”.

\textsuperscript{15} The Parmalat scandal was also partly based on a system of fictitious documents. Grant Thornton, Parmalat’s auditor, has claimed that a letter from Bank of America vouching for € 4 billion of cash in Bonlat was a forgery good enough to fool them (EC 2004).
these two decisions and summarizes our empirical observations regarding the different types of information and forms of trust that impact on investors’ behavior.

**Insert Figure 1 about here**

Zucker’s (1986) distinction between characteristic-based, process-based and institutional-based trust is helpful in understanding why investors felt confident when putting their money into Madoff’s funds. First, it seems that their personal encounters with Madoff as well as the information they had obtained about Madoff’s background and personal achievements (former chairman of the NASDAQ, a major donor for various charities, etc.) created a considerable amount of characteristic-based trust. Second, Madoff’s fund had an impressive and long-lasting track record, which apparently fostered investors’ belief that this was an investment with a sustainably high performance (process-based trust). Third, our interviews with investors suggest that many of them were comforted by the fact that Madoff claimed to have been regularly examined by the SEC even though this was not true. These references to the SEC instilled institutional-based trust. Taken together, these three types of trust allowed investors to put their money into the fund without much hesitation.

Investment decisions are not one off events. Investments can, in most cases, be undone by withdrawing the money and investing it elsewhere. There must therefore be sufficient reasons for investors to maintain their investment over time. The right part of figure 1 shows the types of information and the forms of trust that created the momentum. These forms of trust and types of information, in turn, caused investors to keep their money with Madoff. Overall, there was not much change in the type and level of information that investors received. Some investors had personal encounters with Madoff which usually strengthened their trust in him; he was perceived as a very “kind person” (see quotation of investor 19 above). Others were comforted by the fact that Madoff claimed to have been examined by the SEC. The most interesting information came in the form of the account statements that Madoff regularly sent to the investors. These statements were of particular importance because they could be received only after the initial decision to invest. These statements had a high level of credibility because of their apparent representation of an underlying economic reality which in retrospect did not exist. The account statements produced process-based trust by indicating that the fund was performing well. Because investors believed that their money was (apparently) increasing from month to month, process-based trust had a high degree of importance for investors (as compared with the other types of trust) before their initial investment decisions.
In summary, our observations suggest a positive relationship between information and trust in which more information (about Madoff and his activities) led to a strengthening of trust, which in turn motivated the investors to maintain their investments.

The limits of transparency: Towards an “intelligent accountability”?

Our observations regarding the role of the account statements that Madoff sent to investors confirm that an increase in information and transparency does not necessarily translate into improved control or accountability (O’Neill 2002; Roberts 2009). More information may simply create an “illusion of transparency” (Roberts 2009, p. 962) or produce a superficial form of accountability that does not allow for questioning the substance of the underlying reality.

For Roberts (2009), an illusion of transparency is particularly likely to occur when information is provided in an abstract form, such as through aggregate performance indicators or other “snapshots” of practice. Roberts contrasts such types of accounts with an “intelligent” form of accountability which, instead of operating at a distance, seeks to engage with the details of practice:

“Whilst transparency must rely on periodic snapshots that capture performance at a moment of time, intelligent accountability extends over time and thereby affords the opportunity to test commitments against outcomes in a way that makes the manipulation of performance less easy, and promotes understanding of the complex interdependencies that underlie discrete indicators. It is typically a face-to-face encounter, rich with information, in which communication is less easily stage-managed and rhetoric can be constantly compared to actual practice” (p. 966).

The argument for a face-to-face accountability seems particularly appropriate for those professions which have traditionally relied on face-to-face contact and whose work has only recently become colonialized by more abstract forms of performance measurement and control (Power, Laughlin, and Cooper 2003). This is particularly true for the public sector (O’Neill 2002; Miliband 2004; Kamuf 2007; Paquet 2007). Financial markets, in contrast, follow a quite different logic. Investments are made primarily on the basis of past results. This is evident from prior empirical studies. Lakonishok, Shleifer, Thaler and Vishny (1991), for example, provide evidence that fund managers are evaluated on the aggregate performance of funds and on their individual stock selections. This emphasis on past performance may lead to
“window dressing strategies”, in that fund managers tend to oversell stocks that have performed poorly. Sales of poorly performing shares accelerate in the fourth quarter, when funds’ portfolios are closely examined by sponsors and investors; and only if results are not satisfactory, would there be a more detailed discussion of the investment process. Similarly, Chevalier and Ellison (1999) examine the labor market for mutual fund managers. They find that “termination” is performance-sensitive, especially for younger managers. This is consistent with investors being focused on performance and results.

The dominant focus on results allows investment managers to direct attention away from the details of their investment processes and strategies. This is indeed what we observed in the case of Madoff as well: Madoff refused to answer questions about his business practices or his investment strategies. He never provided explanations or monthly performance assessments, even informally, and even went so far as to threaten to expel some investors who asked too many questions. Access to Madoff’s offices for on-site due diligence was very limited or even denied (Gregoriou and Lhabitant 2009). To some extent, such an attitude is consistent with the notion of proprietary costs (Verrecchia 1990a): if an investment manager were to disclose his strategies in detail, his ability to generate an abnormal return would disappear because the strategy would be imitated by others. Madoff cleverly mobilized this argument, thereby justifying the low level of “intelligent” accountability provided to the investors.

Madoff furthermore created a “transfer of accountability” by referring to the role of the SEC. This transfer was to a large extent artificial since Madoff was not registered as an investment advisor with the SEC until September 2006. Until then, he avoided registration by using a regulatory loophole: registration was not mandatory for investment advisors with fewer than fifteen clients. Madoff maintained that he had fewer than fifteen feeders (he was allowed to count each feeder as one client, regardless of the number of final investors). He could therefore operate without being exposed to the random audits of the SEC.

Consequently, one insight from our study pertains to the difficulty of achieving an “intelligent accountability” for individual investors as called for by Roberts (2009). “Intelligent accountability” is arguably more realizable for institutional investors. Institutional investors have a more intimate relationship with fund managers and are more capable than individual investors to challenge fund manager’s actions (see Roberts et al. 2006). Such role for institutional investors was advocated as early as 1992 by legal scholars (see Black 1992 for instance). To some extent, the U.S. law has also conferred such a monitoring function on institutional investors, in that the U.S. congress has exempted funds from registration if the
issuer privately offers its securities to purchasers who are “sophisticated investors” (Section 4(2) of the Securities Act). The investors to whom private offerings may be made are considered to be sophisticated investors because they have the resources and financial expertise to obtain access to, and evaluate, information concerning the offering that they deem significant for their respective investment decisions and investment objectives. Thus, they are considered to “have the wherewithal to ‘fend for themselves’” (Smith 2010, p. 218).

However, in the case of Madoff, institutional investors did not create an “intelligent accountability” relationship, nor adequately conduct analyses that would have allowed them to challenge Madoff’s arguments. For example, the Fairfield Sentry Ltd hedge fund (one of Madoff’s feeder funds) described the investment strategy that Madoff applied as a split-strike strategy. A split-strike strategy consists in acquiring simultaneously a basket of stocks highly correlated to the S&P 100 index, call and put options to create a ceiling and a floor for the gains and losses from the acquired stocks. In theory, this strategy allows managing risks while taking advantage of the high return from the acquired stocks (Bernard and Boyle 2009). Using advanced simulation techniques, Bernard and Boyle (2009) show, however, that Madoff’s returns lie well outside theoretical bounds and should have therefore raised suspicions about Madoff’s performance. In addition, while past research suggests that institutional investors have an information advantage due to private information disclosed by firm management (Baik, Kang, and Kim 2010), in our case this advantage, if it existed, was apparently not sufficient to detect the fraudulent behavior of Bernard Madoff. Thus, the illusion of transparency, extended even to “sophisticated” investors.

**Remedies**

Some suggestions can be advanced to potentially alleviate the dangers that accompany the illusion of transparency in financial decision making. The first suggestion would be to extend the scope of the controls performed by institutions like the SEC, which would then lead to an enhancement of institutional-based trust. Since 1933, U.S. federal law has regulated the offering of securities to the public. The purpose of the Securities Act of 1933 is to “provide full and fair disclosure of the character of securities sold in interstate and foreign commerce […] and to prevent frauds in the sale” of securities. This is accomplished primarily by requiring registration of offerings of securities to the public with the SEC. The Securities Act provides an exemption from the registration requirements for issuers who offer securities to sophisticated investors because these investors have the resources and financial expertise to obtain access to, and evaluate, information about the security they deem significant for their
investment strategy (section 4.2 of the Securities Act). In other words, the federal statute recognizes that sophisticated investors may not need the controls provided by the SEC. Such a view is questionable given the Madoff fraud (Smith 2010), and as a result there have been calls for an extension of the scope of the SEC investigations.

A second suggestion would be to sensitize investors to the impact that characteristic-based and process-based trust may have on their decisions. Connections based on characteristics facilitate information transfers, but they can also be channels for favoritism or a substitute for an “intelligent accountability”. Therefore, characteristics-based trust should not ordinarily form the basis for investing by individual investors, even though this appears to be a logical way to proceed in normal every day decision making processes. Similarly, past returns, which form the basis for process-based trust in investment decisions, are not necessarily predictive of future performance in any type of investment. Instead, they may be used strategically by investment managers to comfort investors and create an illusion of security. Furthermore, in an era of hyper-reality, the representations contained in account statements may not accurately portray an underlying economic reality, or, more importantly, there may be no reality underlying the representations. As a result, the individual investor must also be skeptical of process-based trust.

Despite all efforts in this direction, it will still remain difficult to entirely overcome the problems associated with misplaced trust and deceiving forms of transparency. We therefore argue that, in addition to the above-mentioned remedies, one way forward for investors to avoid falling prey to fraudulent behavior is to apply some rather basic rules when making investment decisions. One possibility would be to explicitly foreclose particular forms of exchange in which trust might, over time, come to influence one’s decisions. Our interview with the CFO of an organization that decided not to invest with Madoff provides an example of such a mechanism. The CFO explained that his organization never considered investing with Madoff because they “had a firm policy against investing in funds that were managed by members [of their investment committee]” and because they required an independent custodian for any management account investment (Non-investor 1). Rules of this nature prevent against entering into certain types of investments even when there are “good” reasons to do so, such as high past performance, reputation, or an exclusive right to invest.

Another possibility would be to more strongly diversify one’s investments (see Makower and Marschak 1938; Markowitz 1952; Samuelson 1967). Diversification allows investors to reduce risk by holding a variety of different types of assets in their portfolio. The diversification principle can also be applied to the intermediaries used by investors. Even if
investors cannot entirely rule out cases of fraud, diversification among different intermediaries at least allows them to reduce the relative impact of such events on their wealth.

8. Conclusion

In this paper, we use the investment fraud of Bernard Madoff to inquire into the possibilities and limits of an “intelligent accountability” (Roberts 2009) in the context of financial decision making. Drawing mainly on interviews with individual investors and their letters, we demonstrate that institutional-based, characteristics-based and process-based trust supported investors’ decisions to put their money into the Madoff fund. In addition, we find that the written account statements regularly sent by Madoff provided an illusion of transparency. Rather than creating skepticism with respect to Madoff’s transactions, these statements comforted investors by showing that the investments performed well. This supports the idea that greater transparency does not necessarily lead to more accountability. Moreover, our paper raises doubts about the possibility of remedying this situation through more “intelligent” accountability in the form of face-to-face contacts between investors and investees. Not only are financial markets characterized by action at a distance; there is also a risk, as evident in the Madoff case, that face-to-face contacts, once they take place, may be used in a manipulative way to comfort investors and win their trust.

In methodological terms, we decided to employ a qualitative approach in this study, conducting interviews with individual investors in order to learn about the rationales behind their investment decisions. We believe that a qualitative approach is very appropriate for uncovering the dynamics of trust and accountability that are at the heart of our paper. Yet, we also acknowledge that this does not come without limitations. The rather small size of our sample does not allow for the same type of statistical generalization that a large sample could offer. While we do detect patterns in our data, the generalizations that we offer on the basis of these patterns must rely to an important extent on the persuasiveness of the theoretical arguments themselves.

When conducting our interviews, we were aware of the difficult experiences that many of our interviewees had gone through and were continuing to go through. We therefore decided to keep the conversations rather short and to focus our questions on investors’ involvement in the Madoff case. Perhaps, a more comprehensive consideration of our interviewees’ “life projects” (involving, for example, their experiences with investments in the past) could have shed some additional information on their decisions in the Madoff case. We can only
encourage future research to explore this possibility and follow people’s investment decisions over a longer period of time. Such longitudinal studies have provided rich insights in sociology and policy analysis (e.g., Halsey, Heath, and Ridge 1980) and they may prove also fruitful for our understanding of people’s behavior on financial markets, especially regarding questions of trust and accountability. In this respect, there is also scope to examine in more depth potential differences between individual and institutional investors’ behavior. While some researchers have looked at the roles of institutional investors (e.g., Collins, Gong, and Hribar 2003) and their interactions with company managers (e.g., Roberts et al. 2006), we still know little about institutional investors’ ability to detect mismanagement or fraud in financial markets.

Finally, an interview approach is retrospective in nature and therefore relies upon interviewees’ recollections of their past actions and experiences. To complement such an approach, it may be worthwhile to explore the micro-dynamics of trust and accountability in a more real-time setting. Experimental studies, which constitute a well-established method in accounting research, may be a way forward in this respect.
Appendix 1: Interview guide

Before the interview starts:

- Explain the purpose of the interview: to gain a better understanding of what happened between Madoff and investors; stress the academic purpose.
- Explain that we are interviewing several investors and will treat them all anonymously. Names, investment sums etc. won’t be disclosed.
- Ask for permission to record the interview, as this is important for the academic purpose.

Questions:

1. To start with, could you please explain how you were affected by Madoff’s fraud?
   - When did you first invest with Madoff?
   - How did you invest? Directly or indirectly? Through whom?
   - Why did you invest?
   - Do you know other people who had invested with Madoff? Whom?

2. Why did you invest money with Madoff?
   - Did you know that you had invested money with him?
   - Had you heard about Madoff before? From the media? From other people?
   - Did you know anything about the performance of Madoff’s investment funds before you invested? If yes, what did you think about this performance?

3. How was the performance of your investment (before the fraud was detected)?
   - What did you think about this performance?

4. Did you ever have doubts about your investment?
   - If yes, why? And what did you do in response to these doubts
   - If no, why not?

5. What kind of information did you receive from Madoff regarding your investment?
   - records/reports? If yes,
     - What was stated on these records?
     - What did you think about these records?

6. Did you ever meet Madoff personally or talk to him? (see also question 8.)
   - If yes, what did you talk about?
   - What impression did he make on you?
     Did the conversation increase or decrease your trust in the investment?

7. Did you meet some of his employees or talk to them?
- If yes, what did you talk about?

8. Did you ever ask Madoff or one of his employees for more information regarding your investment?
- If yes: What kind of information did you ask for? → ask interviewee to narrate the episode in detail
  - What was the answer?
  - Did the answer satisfy you? At which point did your inquiry stop? Why?
- If no: Why not?
Appendix 2: Example of a statement received by an investor

<table>
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<th>DATE</th>
<th>BWTG RECEIVED OR LOANS</th>
<th>SELL DELIVERED OR SHORT</th>
<th>TKN</th>
<th>DESCRIPTION</th>
<th>PRICE OR SYMBOL</th>
<th>AMOUNT DEBITED TO YOUR ACCOUNT</th>
<th>AMOUNT CREDITED TO YOUR ACCOUNT</th>
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<td>NO BALANCE FORWARD</td>
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<td>BELL ATLANTIC CORP</td>
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<td>98450</td>
<td>128</td>
<td>CITICORP</td>
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<td>COLUMBIA/HCA HEALTHCARE CP</td>
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<td>2/18</td>
<td>338</td>
<td>98702</td>
<td>61</td>
<td>CISCO SYSTEMS INC</td>
<td>20,418.00</td>
<td></td>
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</table>

PLEASE RETAIN THIS STATEMENT FOR INCOME TAX PURPOSES
References


Arvedlund, E. 2001. Don't ask, don't tell: Bernie Madoff is so secretive, he even asks his investors to keep mum. Barron's (May 7): 26-27.


tVideoInfo:segmentUtilities).


Walsh, J. 1998. *You can't cheat and honest man - how Ponzi schemes and pyramid frauds work... and why they're more common than ever*. Los Angeles, CA: Silver Lake Publishing.


Figure 1  Proposed relationship between information and trust

Information  Trust  Decision  Information  Trust  Decision

Face-to-face encounters
Information about the person
Information about past returns
Information about SEC controls

Characteristic-based trust
Decision to invest
Process-based trust

Decision to maintain the investment or to invest more
Decision
Information
Trust
Information
Trust
Information
Trust

Decision to invest
Information about returns (Statements)
Information on further SEC controls
Process-based trust
Institutional-based trust
Characteristics-based trust
Institutional-based trust
Face-to-face encounters
Information about the person
### Table 1

**Chronology**

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1938, April 29</td>
<td>Bernard Madoff born in New York City</td>
</tr>
<tr>
<td>1960</td>
<td>Madoff graduates from Hofstra College, Hempstead, New York, with a degree in political science. He qualifies as a general securities representative (salesperson) and general securities principal (allowing him to establish a securities sales and trading firm). The securities firm of Bernard L. Madoff Investment Securities is founded and registered with the SEC as a broker-dealer.</td>
</tr>
<tr>
<td>1962</td>
<td>Accountants Frank Avellino and Michael Bienes begin raising investments for Madoff, promising returns of 12 to 20%.</td>
</tr>
<tr>
<td>1967</td>
<td>Bernard Madoff’s brother, Peter, graduates from Fordham Law School and joins his brother’s firm as a partner.</td>
</tr>
<tr>
<td>1971</td>
<td>The NASDAQ over-the-counter securities trading market is created.</td>
</tr>
<tr>
<td>1984</td>
<td>Madoff becomes a member of Board of Governors of National Association of Securities Dealers (securities self regulatory organization).</td>
</tr>
<tr>
<td>1985</td>
<td>Cohmad Securities is founded (the legitimate part of Madoff’s securities trading business).</td>
</tr>
<tr>
<td>1990</td>
<td>Madoff becomes Chairman of NASDAQ.</td>
</tr>
<tr>
<td>1992</td>
<td>Avellino and Bienes are accused of illegally selling securities to thousands of investors over three decades. Madoff refunds the money.</td>
</tr>
<tr>
<td>1993</td>
<td>Avellino and Bienes are forced to shut down and pay a fine.</td>
</tr>
<tr>
<td>2000</td>
<td>Harry Markopolos submits his first allegations concerning the Madoff fraud to SEC in Boston.</td>
</tr>
<tr>
<td>2005</td>
<td>“The World’s Largest Hedge Fund is a Fraud” (Harry Markopolos).</td>
</tr>
<tr>
<td>2006</td>
<td>SEC opens an investigation of Madoff.</td>
</tr>
<tr>
<td>2006</td>
<td>Madoff registers as an investment adviser</td>
</tr>
<tr>
<td>2007</td>
<td>SEC closes investigation of Madoff, finding no fraud.</td>
</tr>
<tr>
<td>2008, Dec. 10</td>
<td>Madoff confesses to his brother and his sons.</td>
</tr>
<tr>
<td>2008, Dec. 11</td>
<td>He is arrested by the FBI.</td>
</tr>
<tr>
<td>2009, March 12</td>
<td>Madoff pleads guilty to eleven criminal charges.</td>
</tr>
<tr>
<td>2009, June 29</td>
<td>He is sentenced to 150 years in federal prison.</td>
</tr>
<tr>
<td>2010, December 11</td>
<td>Suicide of Mark Madoff, Bernard Madoff’s eldest son.</td>
</tr>
</tbody>
</table>

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16 Two detailed chronologies have been published (see Kirtzman 2009, p. 273-279; Sander 2009, p. 255-259).