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**A LESSON IN MORAL HAZARD: WHY WE SHOULD THANK
BERNIE MADOFF**

Walter E. Block, Ph.D. and Corey Jones

ABSTRACT:

Bernie Madoff is akin to the canary that miners bring to their jobs for safety. He resembles the Distant Early Warning System that was installed to protect the U.S. from attack. He has not been appreciated as such. It is time, it is past time, that he be “credited” with this important role he has played.

Purpose: to criticize the SEC

Design: utilize their inaction in the Madoff case

Findings: the SEC was derelict in its duty

Originality: we know of no publication in favor of Bernie Madoff

Key words: Moral hazard; Securities and Exchange Commission;
Economic Regulation

JEL category: D60, G14, G28

**A LESSON IN MORAL HAZARD: WHY WE SHOULD THANK
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*Walter E. Block, Ph.D. ** and Corey Jones**

“It is hard to imagine a more stupid or more dangerous way of making decisions than by putting those decisions in the hands of people who pay no price for being wrong.”¹

I. INTRODUCTION

On March 12, 2009, Bernard L. Madoff pled guilty to eleven counts of fraud, money laundering, perjury, and theft, carrying a potential sentence of over 150 years.² Bernie Madoff, as he was known on Wall Street, had orchestrated the biggest Ponzi scheme in the history of finance, robbing an estimated “\$65 billion in paper wealth and \$17.5 billion in cash” from investors through the investment advisory side of his business, Bernard L. Madoff Securities, LLC.³ In a Manhattan federal court room, Mr. Madoff apologized to his victims, indicating that he had “deeply hurt many, many people” and stating plainly, “I cannot adequately express how sorry I am for what I have done.”⁴

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¹ Thomas Sowell, *Wake Up, Parents!*, JEWISH WORLD REV. (Aug. 18, 2000), <http://www.jewishworldreview.com/cols/sowell081800.asp>.

² Press Release, FBI, Bernard L. Madoff Charged in 11-Count Criminal Information (Mar. 10, 2009), <https://archives.fbi.gov/archives/newyork/press-releases/2009/nyfo031009.htm#:~:text=MADOFF%20with%20eleven%20felony%20charges,from%20an%20employee%20benefit%20plan>.

³ Katie Benner, *Victims of Bernard Madoff's Ponzi Scheme to Receive Millions More*, N.Y. TIMES (Apr. 12, 2018), <https://www.nytimes.com/2018/04/12/business/madoff-ponzi-scheme-compensation.html>.

⁴ Diana Henriques & Jack Healy, *Madoff Goes to Jail After Guilty Pleas*, N.Y. TIMES (Mar. 12, 2009), <https://www.nytimes.com/2009/03/13/business/13madoff.html>.

Fresh off the discovery of his scheme in late December 2008, the apology surely rang hollow for his victims and the public in general. While it is hard to argue against the necessity of an apology on behalf of Mr. Madoff, it is easy to claim that beside him, with their own apologies, should have been each and every employee of the U.S. Securities and Exchange Commission (SEC).⁵ This is an independent

⁵ We speak too quickly, here. We are willing to exempt from this charge those SEC employees who wash the floors, clean the bathrooms, sort the mail, etc. For an explanation of the ruling class theory on the basis of which we make this exemption, here is the view of Murray N. Rothbard:

[A]ll States are governed by a ruling class that is a minority of the population, and which subsists as a parasitic and exploitative burden upon the rest of society. Since its rule is exploitative and parasitic, the State must purchase the alliance of a group of "Court Intellectuals," whose task is to bamboozle the public into accepting and celebrating the rule of its particular State. The Court Intellectuals have their work cut out for them. In exchange for their continuing work of apologetics and bamboozlement, the Court Intellectuals win their place as junior partners in the power, prestige, and loot extracted by the State apparatus from the deluded public.

The noble task of Revisionism is to de-bamboozle: to penetrate the fog of lies and deception of the State and its Court Intellectuals, and to present to the public the true history of the motivation, the nature, and the consequences of State activity. By working past the fog of State deception to penetrate to the truth, to the reality behind the false appearances, the Revisionist works to delegitimize, to desanctify, the State in the eyes of the previously deceived public.

Murray N. Rothbard, *The Case for Revisionism (and Against a Priori History)*, MISES INST. (Apr. 7, 2018), <http://mises.org/library/case-revisionism-and-against-priori-history>; see also Walter Block, *Radical Libertarianism: Applying Libertarian Principles to Dealing with the Unjust Government, Part II*, 28 REASON PAPERS, Spring 2006, at 85-109; see also Charles A. Burris, *Who Rules America?*, LEW ROCKWELL (Jan. 18, 2012), <http://archive.lewrockwell.com/burris/burris21.1.html>; see also WILLIAM G. DOMHOFF, WHO RULES AMERICA? (1967); see also WILLIAM G. DOMHOFF, THE HIGHER CIRCLES: THE GOVERNING CLASS IN AMERICA (1971); see also WILLIAM G. DOMHOFF, WHO RULES AMERICA? POWER AND POLITICS IN THE YEAR 2000 (3rd ed. 1998); see also MIKE DONALDSON & SCOTT POYNTING, RULING CLASS MEN: MONEY, SEX, POWER (2007); see also Hans-Hermann Hoppe, *Marxist and Austrian Class Analysis*, 9 J. LIBERT. STUD., Fall 1990; see also JONATHAN R.T. HUGHES, THE GOVERNMENTAL HABIT: ECONOMIC CONTROLS FROM COLONIAL TIMES TO THE PRESENT (1977); see also GABRIEL KOLKO, TRIUMPH OF CONSERVATISM (1963); see also LUDWIG VON MISES, THE CLASH OF GROUP INTERESTS AND OTHER ESSAYS 20 (1978); see also FRANZ OPPENHEIMER, THE STATE (John Gitterman trans., Free Life Editions 1975) (1914); see also Ralph Raico, *Classical Liberal Exploitation Theory: A Comment on Professor Liggio's Paper*, 1 J. LIBERT. STUD., Summer 1977; see also Llewellyn H. Rockwell Jr., *Liberty and the Common Good*, MISES INST. (Dec. 31, 2001), <http://www.mises.org/article.aspx?Id=860>.

agency of the federal government tasked with protecting investors. The SEC created an environment where the economic concept known as moral hazard bred the very criminal activity that it was presumably created to prevent, implicitly reducing the incentive for investors to exercise greater care in their commercial decisions. It is the thesis of the present paper that we should thank Mr. Madoff for helping to expose the incompetence of government regulation where bureaucrats make important decisions on our behalf every day with very little incentive to be effective or efficient.

In section II we discuss the background of our “hero,” Bernie Madoff.⁶ Section III is given over to an analysis of the Securities Exchange Act,⁷ which created the Securities Exchange Commission. The burden of section IV is to probe the relationship between moral hazard and government. We “put it all together” in section V and conclude in section VI.

II. MADOFF

Bernie Madoff was as well-credentialed and experienced as you possibly could get in the financial industry. Mr. Madoff “started his own market maker firm in 1960 . . . helped [found] the Nasdaq stock market . . . sat on the board of the National Association of Securities Dealers, . . . and advised the [SEC] on trading securities.”⁸ If

⁶ For a different type of “hero,” see WALTER E. BLOCK, *DEFENDING THE UNDEFENDABLE* (Mises Institute 2018) and WALTER E. BLOCK, *DEFENDING THE UNDEFENDABLE II* (Mises Institute 2019). Both *Defending the Undefendable* and *Defending the Undefendable II* are attempts to explain libertarianism. This philosophy is based upon the non-aggression principle, i.e., one may legally do anything except for initiating violence against innocent people. Thus, murder, rape, theft, arson, kidnapping, fraud, etc., would be prohibited by law, and all other acts would be permissible. However, there are a plethora of behaviors that are either illegal, or hated by all and sundry, and yet, do not at all violate these libertarian principles. It is the function of these books to defend all such behaviors (for example, blackmail (but not extortion), prostitution, addictive drug use, racial and sexual discrimination, dwarf throwing, voluntary slavery).

⁷ Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78qq).

⁸ Stephanie Yang, *5 Years Ago Bernie Madoff Was Sentenced to 150 Years In Prison – Here's How His Scheme Worked*, BUS. INSIDER (July 1, 2014, 6:54 PM), <https://www.businessinsider.com/how-bernie-madoffs-ponzi-scheme-worked-2014-7>.

anyone was to be equated with trustworthiness when it came investing your money, it is safe to say that it would have been Mr. Madoff.

However, for reasons that only he could truly answer, he used that trustworthiness as the perfect disguise for illegal behavior. Mr. Madoff's Ponzi scheme claimed to generate large and consistent returns through a split-strike investing strategy.⁹ This entails "buying a basket of stocks, . . . writing call options against" them and then "using the proceeds from writing the call option to purchase a put option."¹⁰ Instead, Mr. Madoff actually "deposited client funds into [one big] account" at J.P. Morgan Chase "that he [then] used to pay existing clients who wanted to cash out."¹¹ Redemptions were funded by attracting new investors and their money.¹² It was not until the Great Recession of 2008 that Mr. Madoff could no longer keep or obtain enough new money to offset the high volume of redemptions his clients requested.¹³ At this point, the Ponzi scheme fell apart.¹⁴

⁹ Carole Bernard & Phelim Boyle, *Mr Madoff's Amazing Returns: An analysis of the Split Strike Conversion Strategy*, 17 J. DERIVATIVES 62 (2009).

¹⁰ Nick Abe, *Split Strike Is a Valid Strategy, Despite Madoff Scandal*, SEEKING ALPHA (Dec. 22, 2008, 5:90 AM), <https://seekingalpha.com/article/111809-split-strike-is-a-valid-strategy-despite-madoff-scandal>.

¹¹ Adam Hayes, *Bernie Madoff*, INVESTOPEDIA, <https://www.investopedia.com/terms/b/bernard-madoff.asp> (Sep. 24, 2020).

¹² *Id.*

¹³ See Karen Berman & Joe Knight, *What Did Bernard Madoff Do?*, HARV. BUS. REV. (June 30, 2009), <https://hbr.org/2009/06/what-did-bernard-madoff-do>.

¹⁴ Such fraudulent activities are by no means limited to private individuals such as our "hero." Government, too, is guilty. See Gary Galles, *Social Security: The Most Successful Ponzi Scheme in History*, MISES INST. (Nov. 22, 2013), <https://mises.org/library/social-security-most-successful-ponzi-scheme-history>; see also John C. Goodman, *Why Was Social Security Designed Like a Ponzi Scheme?*, FORBES (Aug. 13, 2015, 10:37 AM), <http://www.forbes.com/sites/johngoodman/2015/08/13/why-was-social-security-designed-like-a-ponzi-scheme/#2ae06a10734f>; see also Lawrence Kotlikoff, *America's Ponzi Scheme: Why Social Security Needs to Retire*, PBS (Apr. 7, 2014, 12:50 PM), <http://www.pbs.org/newshour/making-sense/americas-ponzi-scheme-why-social-security-needs-to-retire/>; see also Richard M. Salsman, *Social Security is Much Worse Than a Ponzi Scheme – and Here's How to End It*, FORBES (Sept. 27, 2011, 2:42 PM), <http://www.forbes.com/sites/richardsalsman/2011/09/27/social-security-is-much-worse-than-a-ponzi-scheme/#2fa2c532cdc6>; see also Thomas Sowell, *The Collapsing Social Security Pyramid Scheme*, WND (Feb. 8, 2016, 7:26 PM), <http://www.wnd.com/2016/02/the-collapsing-social-security-pyramid-scheme/>.

III. SECURITIES AND EXCHANGE COMMISSION

The SEC was created through the Securities Exchange Act,¹⁵ signed on June 6, 1934. Its purpose was to give investors a sense of safety and security when participating in the U.S. stock market. Its conception was a result of the Great Depression, and more specifically, Black Tuesday (October 29, 1929), where the stock market, individual investors, and banks were all burned through speculation on incomplete and bad information, among other things.¹⁶

Specifically, the SEC set forth several new rules. It required more disclosure and strict reporting schedules.¹⁷ All firms offering securities to the public had to register and file regularly.¹⁸ Most importantly, it allowed “civil charges to be brought against” firms and individuals who were considered bad actors.¹⁹ The thought process was that with a government entity such as the SEC overseeing the stock market, investors should no longer have a reason to fear uncertainty; in essence, they were all but guaranteeing certainty.

¹⁵ Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78qq).

¹⁶ See generally David C. Wheelock, *Monetary Policy in the Great Depression: What the Fed Did, and Why*, 74 FED. RESRV. BANK ST. LOUIS REV. 3, 3-27 (1992). What were the even more basic causes of this sorry episode? The federal reserve system and fractional reserve banking. See ROBERT D. AUERBACH, DECEPTION AND ABUSE AT THE FED: HENRY B. GONZALEZ BATTLES ALAN GREENSPAN'S BANK (2008); see also Ryan Grim, *Priceless: How the Federal Reserve Bought the Economics Profession*, HUFFPOST (Oct. 23, 2009, 5:12 AM), http://www.huffingtonpost.com/2009/09/07/priceless-how-the-federal_n_278805.html; see also Robert P. Murphy, *The Fed: The Chicago School's Achilles Heel*, MISES INST. (Dec. 13, 2010), <http://mises.org/daily/4875>; see also Gary North, *How to End the Fed, and How Not To*, MISES INST. (Sept. 10, 2012), <http://mises.org/daily/6175/>; see also RON PAUL, END THE FED (2009); see also Murray N. Rothbard, *The Federal Reserve as a Cartelization Device: The Early Years, 1913-1930*, in MONEY IN CRISIS: THE FEDERAL RESERVE, THE ECONOMY, AND MONETARY REFORM 89-136 (Barry N. Siegel ed. 1984); see also Joseph T. Salerno, *Fractional Reserves and the Fed: Testimony Before the U.S. House Committee on Financial Services, Subcommittee on Monetary Policy (Chairman: Ron Paul)*, 30 FREE MARKET, June 2012; see also Thomas Sowell, *Fed Up With the Fed?*, LEW ROCKWELL (May 5, 2011), <https://www.lewrockwell.com/2011/05/thomas-sowell/fed-up-with-the-fed/>.

¹⁷ See Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78qq).

¹⁸ See *id.*

¹⁹ Andrew Beattie, *The SEC: A Brief History of Regulation*, INVESTOPEDIA, <https://www.investopedia.com/articles/07/secbeginning.asp> (June 25, 2019).

IV. MORAL HAZARD AND GOVERNMENT

Governments can “play a critical role in the wealth-creating process by enforcing property rights and contracts—legal mechanisms that facilitate voluntary transactions.”²⁰ Moral hazard is defined as “post-contractual increases in risky or negative behavior.”²¹ In other words, if you purchase car insurance, you are more likely to drive erratically than you otherwise would have without this protection. Government should *not* be *guiding* the decision-making of market participants. This gives market participants a false sense of security, and in the event, an unwarranted one.

The existence of the SEC and the false and illusory “protection” it offers encouraged investors to engage in excessively risky investments. There is no incentive for the SEC to perform its duties effectively or efficiently; it is a government regulatory body, and it *cannot* fail. Investors must not put blind trust in something that faces zero consequences for a job poorly done. As Duff puts the matter:

The official recognition of a problem—whether it be urban blight, drug abuse, or illiteracy—by a federal agency has historically served to institutionalize the problem itself. The moral hazard of government first comes to light as it rewards itself with additional funding in direct proportion to its failure to discharge any significant facet of its legal mandate.²²

V. PUTTING IT ALL TOGETHER

“It was all made up and his story was so fanciful and far-fetched that the SEC should have seen through it immediately. And they didn't.”²³

The SEC’s ineptness related to the Madoff Ponzi scheme was so unbelievable that someone actually wrote a book about the explicit

²⁰ LUKE M. FROEB ET AL., *MANAGERIAL ECONOMICS: A PROBLEM SOLVING APPROACH* 17 (5th ed. 2018).

²¹ *Id.* at 320.

²² Michael R. Duff, *The Moral Hazard of Government*, FEE (June 1, 1994), <https://fee.org/articles/the-moral-hazard-of-government/#0>.

²³ *Madoff Whistleblower: SEC Failed to Do the Math*, NPR (Mar. 2, 2010, 12:00 AM), <https://www.npr.org/templates/story/story.php?storyId=124208012> (quoting Harry Markopolos).

warnings he personally delivered to them for over more than a decade. That someone is Harry Markopolos, a Chartered Financial Analyst, Certified Fraud Examiner, and author of the book, *No One Would Listen*.²⁴ In other words, Mr. Markopolos was a private citizen, working outside the scope and relatively unlimited budget of government, who easily identified the unrealistic returns and odd characteristics associated with Madoff's investment activities. Take it directly from Markopolos and his book:

Tens of thousands of lives have been changed forever because of the SEC's failure. Countless people who relied on that agency for the promised protection have lost more than can ever be recovered. In some cases, people lost everything they owned. And truthfully, the SEC didn't even need to conduct an extensive investigation. My team had given them everything they needed. With the materials we submitted, it would have taken investigators no more than the time it took to ask Madoff three questions for his fraud to be discovered and his operation to be shut down.²⁵

In the aftermath of Madoff's confession and conviction, further investigation indicated that this criminal had in fact never actually executed a single trade on behalf of his clients.²⁶ Statements were falsified and indicated ties to other firms, such as Fidelity, despite there actually being no such relationship ever established.²⁷ Moreover, monthly statements contained discrepancies between stock prices listed on the statement verses "the actual prices at which they traded on Wall Street."²⁸

Note that the SEC's most recent budget request for fiscal year 2019 was \$1.6 billion dollars.²⁹ Such funding is quite comical when

²⁴ HARRY MARKOPOLOS, *NO ONE WOULD LISTEN: A TRUE FINANCIAL THRILLER* (2011).

²⁵ *Id.* at 8.

²⁶ Jason Szep, *Madoff's Fund May Not Have Made a Single Trade*, REUTERS (Jan. 15, 2009, 7:58 PM), <https://www.reuters.com/article/us-madoff-trades/madoffs-fund-may-not-have-made-a-single-trade-idUSTRE50F0BY20090116>.

²⁷ *Id.*

²⁸ *Id.*

²⁹ Kurt N. Schacht, *SEC, Strapped for Funds, Can't Police Financial Markets*, HILL (July 9, 2018, 9:30 AM), <https://thehill.com/opinion/finance/396064-sec-strapped-for-funds-cant-protect-investors>.

you consider the Madoff Ponzi scheme evidence. Every component of the SEC's existence was built around giving investors a sense of safety and security. And, in one of the biggest financial crimes in history, when one of the biggest red flags conceivable showed up at its doorstep, it did absolutely nothing.³⁰ Because of the SEC's initial lack of action against Mr. Madoff, investors took this as an indication of his trustworthiness.³¹ Thus, they felt they had some sort of insurance policy for investors which would enable them to drive their car (or capital in this case) more erratically than they otherwise would have.

VI. CONCLUSION

The SEC failed. The government failed. It could not be clearer, and in the biggest, most noticeable way possible. Yet, the SEC still retains its power as the authority on helping investors determine the safest and most secure participation in the stock market. In fact, the SEC has not been penalized. Instead, it has been granted additional authority in the aftermath of its failure involving the Madoff Ponzi scheme.³²

The SEC's website, SEC.gov, lists its improvements "Post-Madoff," such as better tip/complaint management and protections for insiders who want to whistle-blow.³³ The hope is that it has

³⁰ Sleeping at the switch is what comes to mind in this regard. Sheer incompetence is another.

³¹ Jennifer Liberto, *SEC investigation: We missed Madoff*, CNNMONEY.COM (Sept. 2, 2009, 8:52 PM), https://money.cnn.com/2009/09/02/news/economy/Madoff_SEC_investigation/index.htm.

³² This is far from the only case where a government agency failed, dismally, and yet remains in operation. For example, the levies of the Army Corp of Engineers fell in the aftermath of Katrina, and yet this organization still exists. See William L. Anderson, *Katrina and the Never-Ending Scandal of State Management*, MISES INST. (Sept. 13, 2005), <http://www.mises.org/story/1909>. If the Mississippi River was privately owned and committed this egregious error, there is little doubt this property would have passed on to more effective ownership. See generally WALTER E. BLOCK AND PETER LOTHIAN NELSON, *WATER CAPITALISM: THE CASE FOR PRIVATIZING OCEANS, RIVERS, LAKES, AND AQUIFERS* (2015) (making the case for turning the world's waterways to private enterprise. Some 1900 people died in the aftermath of Hurricane Katrina, but this was really the fault of the Army Corp of Engineers, whose levies failed. This would also solve the tragedy of the commons on the oceans and fish disappearance).

³³ *The Securities and Exchange Commission Post-Madoff Reforms*, SEC, <https://www.sec.gov/spotlight/secpostmadoffreforms.htm> (last visited, Jan. 26, 2021).

implemented a “silver platter” policy as well: when incriminating evidence against a bad actor is handed to it directly and it actually acts upon it, expeditiously.³⁴

It is highly unlikely that any of Mr. Madoff’s victims or the general public have ever considered thanking him for his actions. In fact, we wager that not one investor he defrauded has sent him a single birthday card since he has been housed in federal prison. That being said, it is important to recognize that Mr. Madoff’s Ponzi scheme gave us one gigantic example of expensive bureaucratic inaction in action. Government regulation is incompetent and creates moral hazard, or a false sense of security, for its citizens not only in the financial industry but in all aspects of everyday life. This example can be replayed in practically all industries into which government meddles.

According to Yilmaz, “federal regulations take too much time, money, and resources to deliver results. Each year, Americans spend \$710 billion to finance federal regulatory agencies and to comply with federal regulations.”³⁵ It is time that we were allowed an alternative: more effective and efficient private, voluntary, and professional third-party watchdog organizations, not too dissimilar to the service that Mr. Markopolos attempted to provide to the SEC.³⁶

³⁴ “Expediently” is not a word usually associated with government operation, as anyone who has ever visited the Motor Vehicle Bureau, or the U. S. Post Office, can readily attest.

³⁵ Yesim Yilmaz, *Private Regulation: A Real Alternative for Regulatory Reform*, CATO INST. (Apr. 20, 1998), <https://www.cato.org/publications/policy-analysis/private-regulation-real-alternative-regulatory-reform>.

³⁶ There are numerous cases in point. Fitch, Moody’s and Standard and Poor as private financial watchdogs; Good Housekeeping’s Seal of Approval as a consumer goods watchdog. For another case: all too many people think that food and drug safety can only be provided by government organizations such as the Food and Drug Administration. This is erroneous. Private companies and certification agencies do a better job than putting all of our eggs in one FDA basket. When private sector participants err, they lose money; too many mistakes and bankruptcy beckons, leaving room for more efficient competitors. When organizations such as the FDA fail (for example, thalidomide) or the U.S. Post Office, they continue interminably.