EXAMINING THE FORMS OF TRUST IN OPERATIONS WITHIN FINANCIAL MARKETS: THE CASE OF THE MADOFF PONZI SCHEME

ABSTRACT

Trust plays an important role in facilitating the efficient operation of all types of markets. In the case of modern financial markets, which are extremely complex in structure and whose products include significant tacit elements, trust is particularly critical. This paper will use Fiske's (1992) categorization of relationships to explore of the role of trust between those operating within financial markets especially between the providers of finance and those who use it. It will show, by examining Madoff's multi-billion dollar fraud how easily trust can be exploited and will suggest that the contradictory statement 'trust but verify' is appropriate to financial exchanges.

KEYWORDS: Trust; networks; finance; relationships; fraud.

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INTRODUCTION

Trust plays an important role in facilitating the efficient operation of all types of markets. In the case of modern financial markets, which are extremely complex in structure and whose products include significant tacit elements, trust is particularly critical. This paper will use Fiske's (1992) categorization of relationships to explore of the role of trust between those operating within financial markets especially between the providers of finance and those who use it. It will show, by examining Madoff's multi-billion dollar fraud how easily trust can be exploited and will suggest that the contradictory statement 'trust but verify' is appropriate to financial exchanges.

MODERN FINANCIAL MARKETS AS NETWORKS

The modern financial marketplace is an extremely complex network of organizations characterized by eight distinctive features, combinations of which exist in other networks. However, arguably, it is only in financial markets that all eight are found. First, behind the 'visible' activity is an intricate web of business-to-business exchanges. For example, a case pursued by the SEC[1] against Goldman Sachs involved not only several organizations based in a number of different countries but also several different types of financial instruments (Guerrera et al., 2010). Second, within this web of exchanges the interdependencies are systemic because they are founded on the assumption that all parties behave prudently. Third, this is a genuinely global market as is indicated by the fact in that in 2009 the financial stability of Deutsche Industriebank was threatened by the growing number of mortgage defaults occurring in the USA private housing mortgage (Tett, 2009, pp.204-9). Fourth, most financial institutions are lenders and borrowers at the same time. Indeed "Modern financial architecture consists of an interwoven network of financial obligations." (Brunnermeier, 2009, p.96) Fifth, an organization's ability to obtain finance is often dependent upon a third party providing assurances of the quality of the securities on offer (Morrison and Wilhelm, 2007). Sixth, there are firms whose function is not to manage funds themselves but only to design and market financial instruments for other organizations to use. Thus Oliver Wyman, a significant financial consultancy, claims to provide "leading financial institutions with custom solutions covering all aspects of risk management, including its application to financial management." Seventh, there are individuals whose reputations are so great that they often play a significant part in both the setting up and implementation of transactions. An example is that it was predicted that if Mr. Guy left Gartmore plc, where he managed just two (worth £2 billion) of Gartmore's many funds, then Gartmore's total earnings would be reduced by 40% (Johnson et al., 2010, p.14). Eighth, is the importance of financial transactions' tacit elements. Indeed Davidoff, Morrison and Wilhelm comment that: "Tacit contracts of this type (viz. bilateral tacit contracts) abound in finance and in wider economic life." (2011, p.17) These eight features plus the multiplicity of financial instruments means that few people fully understand how financial markets work and that tracing who owes what to whom is a complex exercise often fraught with uncertainty.

[1] SEC is the United States Securities and Exchange Commission whose mission "is to protect investors, maintain fair, orderly, and efficient markets, and to facilitate capital formation." (SCCMIGPE, 2009, p.49)

THE ROLE OF TRUST IN FINANCIAL MARKETS

Markets cannot work without trust because with regard to some elements of an exchange "complete, fully contingent, costlessly enforceable contracts are not possible" (Klein, 1980, p.356). There are two reasons for this. First, many possible contingencies exist and it may be costly or impracticable to specify responses to all of them. Second, transaction costs such as: unforeseen contingencies; the cost of writing contracts; the cost of enforcing contracts; and, the cost of renegotiating contracts (Tirole, 1986 and 1999) may make it very expensive or effectively impossible to measure some types of performance. Relational contracts, which are contracts that contain elements the performance of which cannot economically be verified by third parties (Brown et al., 2004, p.747), are one mechanism for handling such situations. These non-verifiable elements would include tacit and credence factors (Darby and Karni, 1973) which are those that cannot, when starting a relationship, during it or after it, be specified in terms which are subject to objective evaluation and they have to be taken 'on trust' (Blois, 1999). Indeed "Markets could not work without non-calculative trust" (Nooteboom, 2004, p.508) and a complete lack of trust would prevent a party from entering into any exchange because, without it, endless safeguards would be sought.

Such non-verifiable elements are widespread in service products and are particularly common in financial markets where they are often the core of financial products. Therefore trust is particularly needed in such markets. For example, where information about the worth of a share flotation (which has been described as "more an art than a science [*The Economist*, 2011, p.70]) is hard to assess, when measuring service quality is difficult, and the validity of forecasts of market conditions is typically impossible formally to contract upon, then "parties that require this type of information therefore rely upon trusted intermediaries to provide it." (Davidoff, Morrison and Wilhelm, 2011, p.3)

'STARS' IN MODERN FINANCIAL MARKETS

There are individuals within financial markets whose reputations are so great that they are known within these markets as 'stars'. For example, in the 1990's Abby Cohen, then Goldman Sach's chief strategist, was called "a superstar" (Lattman, 2011). Such people often play a significant part in both the setting up and implementation of financial transactions. Their reputations can be so great that, if they change employer, then clients will follow them and in doing so often move substantial funds. People who do not have regular and direct contact with financial markets only become aware of these 'stars' when their activities attract the attention of the general media rather than just the specialist financial media. An example of this phenomenon is Nicola Horlick who, before she became known to the general public by being identified by women's magazines as a role model[2], had established an outstandingly successful record as a fund manager

In financial markets, where the product's elements include both tacit and credence factors, the reputation of such 'stars' assumes a substantial significance. Their reputation for making above average returns on investors' funds acts as a magnet to investors who demonstrate

[2] The media labeled her 'Superwoman' for bringing up five children (one of whom died of leukaemia) while simultaneously pursuing her very successful and high-flying career in the UK financial sector.

great trust in these ‘stars’ by either investing their money in funds managed by the ‘star’ or allowing the ‘star’ to determine where their money should be invested. Once a ’star’s’ reputation is established then they can, if they wish, rapidly extend the range of their activities for, as McKnight et al. pointed out, “if a person has a good reputation, one will quickly develop trusting beliefs about that individual, even without firsthand knowledge.” (2006, p.123) Indeed, even it becomes apparent that a ‘star’ has been less successful than previously it takes some time before they their reputation becomes severely damaged, because: “When many people perceive that an individual has a good reputation, it is harder for a negative event to significantly reduce a high level of trusting beliefs in that individual.” (McKnight et al., 2006, p.131). Indeed this point is illustrated by Horlick, who lost £21 million of her clients’ funds by investing them in a fund run by a fraudster, but still has no problem in attracting clients[3].

FISKE’S RELATIONAL MODELS THEORY

Fiske developed his Relational Models Theory (1992) in an anthropological context but recently it has been developed and applied in several other fields within the social sciences (see for example: Haslam, 2004; Tong et al., 2008; Boer et al., 2011). A basic assumption of Fiske’s theory is that individual behaviour assumes social meaning only in the context of human relations. According to Fiske a human’s social life is defined in terms of their relations with other people and therefore behaviour in a relational context should be the basic unit of analysis. Fiske’s theory proposes that all social relationships are constructed according to just four elemental models because “people relate to each other in just four ways.” (Fiske, 2004, p.3) These four models provide the scripts or schemata that allow individuals to relate to the behaviour of others. The theory assumes that people are inherently sociable and that consequently “the relational models are not merely cognitive capacities: they are intrinsically motivating.” (Fiske, 2004, p.9) As a theory it has the aspiration of being an account of the fundamental forms of social relations and assumes that all aspects of social relationships may be organized by combinations of just these four elementary models.

Fiske’s argument is that relations can be structured with respect to: Communal Sharing Model (CS); an Equality Matching Model (EM); an Authority Ranking Model (AR); or, a Market Pricing Model (MP) [see Table 1]. The core of Fiske’s theory is that “people use the same set of four implicit cognitive schemas to organize all the diverse domains of sociality most of the time.” (Fiske, 2004, p.7) Relational Theory recognizes that these four models can guide behaviour or be used to evaluate a situation only with the use of “implementation rules that specify when they apply, to what and to whom, and how.” (Fiske and Tetlock, 1997, p.259) Although people may use just one of these four models to coordinate a simple interaction, in general “the various aspects of interactions among a dyad or group are governed by more than one relational model.” (Fiske 2004, p.9) and different models may simultaneously apply to aspects of an interaction. Indeed Fiske has commented that: “People commonly use a combination of models… Generally, people string the models together and nest them hierarchically in various phases of an interaction or in distinct activities of an organization.” (1992, p.711). Yet unfortunately, as Haslam has pointed out, “…the general area of relations among relations – how relationships governed by particular models combine, interlock, or conflict with one another – has yet to attract adequate theoretical or empirical

[3] Another example would be Guy Hands who lost £1.75 billion (Foley, 2010) on a single investment but still attracts clients.

attention" (2004, p.53). However, Blois and Ryan (2010, p.8) have argued that, within a specific interaction, the actual behaviours under each of these four models are not independent of each other and that one relational form may dominate the context within which the other models operate.

FISKE'S MODELS AND TYPES OF TRUST

The concept of trust is one which has challenged scholars from a variety of disciplines. Amongst the contentious issues are: the need to differentiate between 'reliance' and 'trust'; what it means to state that an organization 'trusts'; whether or not 'trust' can be sub-categorized and, if so, which are the appropriate sub-categories (Lewicki at al., 2006); and how what have described as "different levels of trust" (Fang et al., 2008, p.90) interact.

This paper adopts the position that: 'trust' is distinct from 'reliance' (Holton, 1994, p. 65); that organizations can exhibit trusting behaviour (Dirks and. Ferrin, 2001); that trust can be subcategorized and that, a small number of categories receive the greatest attention (for example: Lewicki and Bunker, 1995; Sako, 2006); and that, as Fiske's Relational Model Theory suggests, different levels of trust interact in complex ways.

Fiske's discussion of relational models does not specifically take in the concept of trust. However, the following discussion on the basis of discussions in the 'trust' literature suggests how particular categories of trust are related to each of Fiske's four relational models and then considers how these different categories of trust interact with each other. Table 1 is the outcome of this discussion and outlines Fiske's relational models and the related categories of trust.

Thick trust can arise over time between people who: are well known to each other; have established personal bonds with each other; and, respect each other's dispositions and character (Williams, 1988, p.8). In such circumstances, thick trust will develop because the "parties know each other well and have strong incentives for trustworthiness from their relationship itself" (Hardin, 1993, p.506). Although within CS relationships the possibility that others will make incorrect interpretations and/or act presumptively is ever present, there is also a sense of mutual altruism and "expectations of benign action" (Govier, 1994, p.238) and in such a relationship it would be anticipated that thick trust would exist. CS relationships may range from the relatively superficial, say, merely being members of the same financial community through to deep personal relationships encompassing the individual's families.

Goodwill trust is about one's good faith, good intentions, and integrity and whether a party has a reputation for dealing fairly, and caring about a trading partner's welfare (Das & Teng, 2001, p.256). Goodwill trust is likely to develop over time as a result of repeated interactions through which the parties can enhance their mutual understanding of each other (Tomkins, 2001; Langfield-Smith and Smith, 2003). Within EM relationships risks of poor co-ordination and opportunities for delaying the delivery of the reciprocal 'payment' always exist. However, these downsides will be accepted where goodwill trust exists because its existence gives a party enough "confidence in its exchange partner's open commitment to supporting and continuing a focal exchange relationship." (Miyamoto and Rexha, 2004, p.314).

Where the AR model is operational then *system trust* would be applicable. System trust is the belief that the proper impersonal structures have been put into place to enable one party to anticipate successful transactions with another party (Pennington et al., 2003, p.201) because of the trustworthiness of the system. In modern financial markets firms can demonstrate their trustworthiness by such actions as: accepting the requirements of regulatory bodies; and, becoming members of prestigious organizations which are known to impose particular standards of behaviour on their members. System trust has two components. The first is structural assurance - which includes safeguards such as regulatory bodies' legal and voluntary requirements that make the party feel safe in depending on the other party, hence

TABLE I FISKE'S FOUR RELATIONAL MODELS AND TYPES OF APPLICABLE TRUST

FISKE'S RELATIONAL MODELS	APPLICABLE TYPES OF TRUST
Communal Sharing relationships exist where members of a group have something (not always a material 'thing') in common which makes the members of the group in some sense socially equivalent to each other and which also distinguishes members from non members. Within such a relationship some collective responsibility towards each other is expected.	***Thick trust*** arises over time between people who: are well known to each other; have established personal bonds with each other; and, respect each other's dispositions and character
An ***Equality Matching*** relationship is where the parties are distinct but equal with exchanges between them being evaluated by a 'swings and roundabouts' approach rather than exact quantifiable measures. An EM relationship differs from a CS relationship (see below) in that accepting help would come under the CS model while a transaction that entails reciprocity, such as receiving a service from others comes under the EM model.	***Goodwill trust*** is based upon a party's good faith, good intentions, and integrity and whether it has a reputation for dealing fairly, and caring about a trading partner's welfare
Authority Ranking relationships arise where the relationships between parties are determined by a hierarchical ordering in which a party is, for example, higher, better, or more powerful than another.	***System trust*** is the belief that the proper impersonal structures have been put into place to enable one party to anticipate successful transactions with another party.
A ***Market Pricing*** relationship organises interactions with reference to ratios or rates and the parties evaluate exchanges using agreed quantifiable (usually monetary) metrics. In a MP relationship it becomes possible to combine quantities and values of diverse entities.	***Contractual Trust*** is a measure of a party's belief that the other party will carry out its contractual obligations and will behave in a reliable manner and not cheat.

enabling trust. The second component is situational normality – "which makes the situation appear normal and reduces uncertainty in the transaction." Such 'normality' can be created by a party becoming a member of a prestigious organization such as the UK's Confederation of British Industry (Pennington et al., 2003, p.201)

Contractual Trust is a measure of a party's belief that the other party will carry out its contractual obligations – whether written or implied – (Sako, 2006, p.268) and will behave in a reliable manner and not cheat. Contractual trust is often based on written guarantees (Chenhall and Langfield-Smith, 2003) and sustains expectations that the nature of an exchange will be as anticipated. Such agreements, and the belief that they will be honoured, provide both parties in a relationship with the confidence to trade with each other. MP relationships are dependent upon the existence of contractual trust.

Some writers separate out *competence trust*, that is "confidence in the abilities of the other party to perform its share of workload in an exchange" (Lui, 2009, p.344) from contractual trust. However, for a firm to contract with, say, a supplier without believing that the supplier has access to the resources necessary to fulfil the contract would be Machiavellian so this paper takes the position that *contractual trust* assumes the supplier's competence.

Fiske's model implies that all these four types of trust are based upon norms of behaviour. For example, in MP relationships, within which transactions' characteristics may be close to 'discrete', the applicable norms will be quite different than those applicable to transactions which are much more 'relational' such as CS relationships (Macneil, 2000). Norms do set limits to acceptable behaviour and create regular behaviour patterns. However, these 'regular behaviour patterns' are not necessarily all benign. Indeed "norms do no more than increase the probability of one type of action occurring within the choice set available and there is no reason why such action might not involve cheating, shirking or opportunistic behaviour any more than the reverse." (Ivens and Blois, 2004, p.241) Thus the norms applicable to a situation enable parties to an exchange to trust each other with regard to certain categories of activity. In other words there is an acceptance by members of the group of what is the 'what' of "*What* do you trust to them?" (Baier, 1986, p.236). For example, a lawyer must exercise extreme discretion when utilizing any client information. However, there is no reason why a lawyer should be any more or less punctilious than a non-lawyer in, say, applying the rules of golf.

When considering these four 'elemental relational models' it is important to recognize that they "may be used in conjunction with one another in interactions with the same person, and it is unusual for a relationship to take only one relational form." (McGraw et al., 2003, p.220) Moreover, within any one interaction the actual behaviours under each of these four models are not independent of each other and arguably one relational form will be dominant. Thus it would be a poor salesman[4] who was not always conscious that his job is *essentially* to get orders (MP model). Nevertheless the emphasis given to each of the aspects of the interaction will change over time. Thus, if a finance manager knows that he will shortly need to ask for a creditor's cooperation with regard to making repayments later than scheduled he may decide to minimise the AR role and stress EM values. Such a change of emphasis would be short-term and possibly only tactical but there could also be longer term strategic changes which might change the model dominating the on-going relationship from CS to AR to EM to MP or vice versa. For example, where a finance manager senses that a credit market, which has for sometime been one of over-supply, is likely to soon change to one of shortage, then

[4] In financial markets the term 'salesman' is seldom used but there are many employees whose function, is and is recognized by their employers as ***selling*** financial products (see, for example, Tett, 2009.)

they may seek to change the relationship from one dominated by MP to EM or even CS. However, there are some changes of this sort which will meet greater resistance than others especially because they may involve ‘taboo’ trade-offs (Fiske and Tetlock, 1997).

Writers such as Hardin (1993) and Sako (2006) have suggested that there is a hierarchy of trust with contractual trust being the most limited/structured form. What has not been explored is the interaction of these types of trust on each other. That is, how does the existence of, say, thick trust between two managers impact on the nature of the contractual trust which might exist in relation to any MP relationship they have? In the following section the interplay between forms of trust and the effect this has on the functioning, or malfunctioning, of netwroks will be considered through an examination of the Madoff Fraud. This example has been chosen for two reasons. First, because it constitutes the largest known fraud of its kind with the sums involved amounting to at least $50 billion. Second, because of its size this fraud is now well documented and most of these documents are available to the public.

THE MADOFF FRAUD

BACKGROUND

Madoff founded the Wall Street firm Bernard L. Madoff Investment Securities in 1960. The firm became one of the top market maker businesses on Wall Street and at one point, Madoff Securities was the largest market maker on NASDAQ and in 2008 was the sixth largest market maker on Wall Street. The firm also had an investment management and advisory division, which it did not publicize.

Madoff was active in the National Association of Securities Dealers (NASD), a self-regulatory securities industry organization and had served as the Chairman of the Board of Directors and on the Board of Governors of the NASDAQ. The Madoff family had access to Washington's lawmakers and regulators through its long-standing, high-level ties to the Securities Industry and Financial Markets Association (SIFMA) which is the primary securities industry organization. Madoff sat on the Board of Directors of the Securities Industry Association, which merged with the Bond Market Association in 2006 to form SIFMA.

MADOFF’S MODE OF OPERATION

Madoff has admitted that the essence of his scheme was to take client’s funds and, instead of investing it in stocks and shares as the clients expected, simply deposited the money into a Chase Manhattan bank account. When clients wanted their money back, “I used the money in the Chase Manhattan bank account that belonged to them or other clients to pay the requested funds” (New York Post, 2009, p.4) he told a Court. He could maintain his fraud while: a/ more funds were coming in than the ‘dividends’ he paid to his clients plus any withdrawals of capital they asked to make; b/ he escaped effective investigation[5] by the various regulatory authorities and, c/ he avoided being quizzed by knowledgeable

[5] In 2009 Madoff said he could have been caught in 2003, but SEC investigators never asked the right questions.

professionals about his ‘split strike’ investment strategy. An important part of Madoff’s scheme was to draw funds in from multiple sources. These included: other fund managers; institutions with cash reserves; charities; and, high worth individuals. In each of these categories were American and non-American investors to whom he offered an unusually consistent and high rate of return. For example, one of Madoff’s funds in the period 1991-2008 averaged a 10.5% annual return and in 2008, even though the S&P 500 stock index fell by 38%, the fund reported that it was up 5.6% in the period January to November (Appelbaum et al., 2008).

Madoff exploited the trust inherent in the different values and norms found in each of the four of the relational models described by Fiske. The values found in CS relationships “emphasize honesty, helpfulness and kindness.” (Blois and Ryan, 2010, p.7) and these are central components of *thick trust*. Madoff developed CS relationships through his membership of socially elite Jewish clubs. He then used these relationships to encourage fellow members to invest their own and others money in his funds. Indeed “the bonds of trust in ethnic communities make it easier for conmen to strike[6], and that is the case in the Madoff scandal, which hit his Jewish community particularly hard.” (Foley, 2008) Although, CS relationships may range from being relatively superficial through to deep personal relationships, Fiske’s model implies that trustworthiness in such relationships is based upon norms of behaviour. Norms are very often are not explicit and, even where they are stated, are often loosely worded and thus open to interpretation. Nevertheless norms do set limits to acceptable behaviour and create regular behaviour patterns which enable *thick trust* to evolve. Thus members of a community trust each other with regard to certain categories of activity. In other words there is an acceptance by members of the group of what is the ‘what’ of “*What* do you trust to them?” (Baier,1986, p.236). Madoff exploited the *thick trust* which evolves within close social groups and persuaded members of groups to extend their trust in him, as a fellow member of the community, to financial matters – something which was outside the communities’ essential range of common interest. As Markopolos[7] reported:

> “I think one big reason is the feeder funds were preying on the people that they were close to. Ponzi schemes are, above all, an affinity fraud. We saw that in the United States, where Mr. Madoff was Jewish, he preyed on the Jewish community.” (SCCMIGPE, 2009, p.31)

Indeed members of such groups, even if they were prepared to accept sharp practice in other parts of their lives, would regard dishonesty within these relationships as unacceptable.

Goodwill trust is found within EM relationships because “the parties believe in each others’ good faith, good intentions, and integrity”. (Blois and Ryan, 2010, p.6). Madoff developed a series of EM relationships through his willingness to give time and money in support of charitable causes. These charities’ trustees reciprocated by investing their charities’ reserves in Madoff’s funds and it is reported that Jewish charities such as the North Shore-Long Island

[6] In fairness to the much criticised SEC it had issued warnings about what it labelled ‘affinity fraud’ which is found in many groups. See, for example, the $33 million fraud that a member of the Amish community committed against his co-religionists (Adams, 2011).

[7] Markopolos had, over a period of nine years, uncovered evidence that Madoff's wealth management business was actually a massive Ponzi scheme. On several occasions he passed this evidence to the SEC but it was ignored (SCCMIGPE, 2009, p.2).

Jewish Health System lost $5 million and the Julian J. Levitt Foundation lost $6 million (Appelbaum et al., 2008) Moreover his fellow trustees also invested their own money and, in the cases where they were themselves professional financial advisors, their clients' money in his funds. In fact many of the EM relationships Madoff developed were multiplex. Thus, he was not only a generous benefactor to and sat on the Board of New York's Yeshiva University but the University in turn invested some of its reserves with Madoff while other members of the Board advised their clients to make investments in Madoff's funds.

The assumption of those with whom Madoff dealt in this context was that that the exchanges of advice and about investment opportunities were made in good faith. That is, the parties involved believed that *goodwill trust* existed between them. (There was also an over-lap here with CS Relationships as many of the charities with which Madoff was associated had Jewish affiliations and his invitation to be a trustee often arose from social contacts.)

Within AR relationships it is expected that proper impersonal structures have been put into place to enable one party to anticipate successful transactions with another party because of the trustworthiness of the system i.e. *system trust* exists. Madoff was known as pioneering market-maker who had been the Chair of NASDAQ and "was so respected in the agency's inner circles that SEC commissioners sought him out for advice and the commissioners appointed him to its advisory committee on market information in 2000." (Engel and McCoy, 2011, p.217). He was also a noted philanthropist. He developed AR relationships by using this reputation as a leader of Wall Street to command attention and demand 'appropriate' behaviour from investors. Thus he let it be known that: he had turned away some investors; had refused future dealings with some existing investors; insisted that those investors whose funds he accepted should not talk to outsiders[8]; and, had returned funds to investors who asked too many questions. As Markopolos found on a visit to Europe in 2002, many of the investors who invested their funds with Madoff felt they were privileged to be able to do so Markopolos reported:

> "I met with 14 French and Swiss private client banks and hedge fund of funds. All bragged how Madoff had closed his hedge funds to new investors but '*they had special access to Madoff and he'd accepted new money from them.*' " (SCCMIGPE, 2009, p.113)

Madoff also publicly claimed that SEC Chairman Schapiro was a 'dear friend' and SEC Commissioner Walter was a 'terrific lady' whom he knew 'pretty well' – comments which might be interpreted as implying he could achieve easy access to such influential people. Markopolos commented:

> "Mr. Madoff was one of the most powerful men on Wall Street. He owned a prestigious brokerage firm. He and his brother held numerous top-level positions on the most influential industry association boards. Clearly, the SEC was afraid of Mr. Madoff." (SCCMIGPE, 2009, p.7)

Within AR relationships it is expected that proper impersonal structures have been put into place to enable one party to anticipate successful transactions with another party because of

[8] Apparently Madoff would return the funds of any clients who showed any form of disloyalty which could include questioning how he achieved his remarkable returns. In retrospect these few questioning (distrustful?) people must count themselves lucky!

the trustworthiness of the system i.e. *system trust* exists. In fairness to many of those who invested in Madoff's funds the SEC and other regulatory bodies gave no indication of any concern about his activities in spite of: a/ warnings by some, such as Markopolos, in the financial community; and b/ the fact that some leading organizations were privately expressing doubts about Madoff's operations – though, as was reported during the Congressional Investigation, not making their concerns publicly known[9].

> "Congressman Donnelly. 'And these very prominent Wall Street organizations that said, hey, Madoff is a fraud, we stay away, was it in effect a club-like atmosphere where, well, we are not going to say anything about Bernie because, you know, that might come back on our business? Was that atmosphere rife throughout the people you were dealing with?'
>
> Mr. Markopolos. 'In Wall Street there is a code of silence.' " (SCCMIGPE, 2009, p.33)

System trust does rely on members of the system making their concerns known when they doubt other members' integrity. However, it seems that this essential sense of responsibility to the community was effectively non-existent. Indeed Madoff has, given his behaviour, somewhat audaciously criticised other members of the financial markets: "pointing to their 'wilful blindness' and their failure to examine discrepancies between his regulatory filings and other information available to them. 'They had to know,' Mr. Madoff said. 'But the attitude was sort of, *If you're doing something wrong, we don't want to know*.' " (Henriques, 2011)

Although in financial markets automated trading is growing in volume, a great deal of activity is still dependent upon personal interactions at some stage. It is interesting to note for example that UBS's wealth management unit refused to recommend Madoff's fund to its clients because Madoff would not meet with its teams (Master et al, 2010) so that they could question him about his funds and his investment model but also, in particular, assess him as a person so that they could determine how trustworthy he was. In other words to check whether or not it was reasonable to invest *contractual trust* into a relationship with Madoff. Madoff established a lengthy roll of professional investors who invested: their companies'; clients'; individuals'; and, their own money into his fund. For example, in the UK Horlick invested 9.5% (£21 million) of her clients' funds with Madoff and she apparently genuinely saw "the Madoff strategy as offering a stable source of returns (viz. 1-1.2% per month year after year)" (Sherwell and Armitstead, 2008)!! These sophisticated professional investors, in spite of the unusually high returns they were earning, took their due diligence enquiries no further than checking that the SEC was not flagging any concerns with Madoff's operations. They simply accepted that *system trust* existed; that is that the system was trustworthy.

The question therefore is under what conditions is it inappropriate for: organizations; fund managers; charities; and, individuals to invest trust into financial relationships?

IS IT IRRESPONSIBLE TO TRUST IN A RELATIONSHIP?

[9] Markopolos implies that most financial institutions have some dirty washing to hide commenting "And when you live in a glass house, you do not throw stones." (SCCMIGPE, 2009, p.33)

The Madoff story demonstrates how easy it is to create the illusion that a person and institutions associated with them are trustworthy – that they are worthy of trust. Yet without trust, as was pointed out above, markets and networks have great difficulty in operating or can only operate with very high transaction costs (Nooteboom, 2004; Sako, 2006). Indeed, a complete absence of trust would render everyday life untenable for an individual because, as Luhmann pointed out, "an absence of trust would prevent him even getting up from bed in the morning" (1979, p.4). Yet Madoff's behaviour raises the question of 'when is it irresponsible to trust in a relationship?'

Much that is written about inter-organisational activity succumbs to what has been described as "the easy analogy from individual to institutional issues that abstracts from institutional constraints" (Hardin, 1993, p.511). Indeed, it is not uncommon in the B2B marketing literature to find analogies with marriage and personal partnerships being used without any justification (O'Malley et al., 2008). However, in this context there is value in contrasting the nature of trust in B2B relationships with trust within close personal relationships.

Within any close personal relationship such as a marriage or stable partnership it is not normal for parties to follow any of the following three policies:

a/ to regularly formally evaluate the relationship;
b/ to constantly evaluate alternative relationship opportunities; or,
c/ to calculate how divergent the partner's behaviour can be from the expected before dissolving the relationship.

In personal relationships "We inhabit a climate of trust as we inhabit an atmosphere and notice it as we notice air, only when it becomes scarce or polluted" (Baier, 1986, p.234) and we do not sniff around to check whether there is a potential source of pollution. Yet given the nature of business-to-business relationships it seems commercially negligent not do this. For example, an investor should not only conduct a due diligence exercise before committing their funds but they should also constantly up-date this exercise so 'a' is indispensable. The reason for this is that, although some financial regulators do have the power to act very quickly, they can only do this when they are very sure of the legitimacy of their suspicions. It can take time for them to accumulate sufficient evidence to act and the reluctance, noted by Markopolos, of the financial community to report its concerns to the regulators does not help.

Then, given the speed of change in modern financial markets, any competent company should be monitoring alternative opportunities either as possible substitutes for existing business partners or as potential additions to them, so 'b' is also essential.

Finally in business it is crucial to think what, in personal relationships, may be 'the unthinkable'. Thus, while most people understand that it is damaging to a personal relationship to even consider the possibility that a partner might 'cheat', in the business world it is foolish not to consider the consequences of a range of situations which might fundamentally disrupt the relationship. Thus 'c' is an unavoidable necessity.

The problem is that it is natural as relationships continue through time for trust in them, absent any negative experiences, to move "from explicit trust to a habitual and confident state of lack of conscious trust" (Blois, 1999, p.209). Thus where two parties have successfully dealt with each other over a period of time it is perhaps understandable, especially as it can reduce transaction costs, to trust a partner.

There is a Russian Proverb: “trust but verify”. The Madoff fraud acts as a reminder of the risks of trusting and irresponsibility of not seeking verification

CONCLUSIONS

Networks can only operate efficiently where trust exists between the members of the network. In those networks, such as those found in financial markets where the tacit elements of many products are of crucial importance, the trust existing between the individuals involved in relationships is of greater significance. Such individuals fulfil more than one role within these relationships and, although different types of trust are applicable to each role, these types of trust interact. As the Madoff fraud showed trust established within one role can effectively ‘infect’ trust in another role. Thus trust built up within, say, a CS relationship may make it less likely that the maxim ‘trust but verify’ will be applied within the MP component of the relationship. However, as Lord Justice Bowen (1883) said: “Mercantile genius consists principally in knowing whom to trust and with whom to deal”.

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