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The Sociology of Financial Fraud

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CHAPTER 20

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THE SOCIOLOGY OF FINANCIAL FRAUD

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If there is an Urtext for the sociology of fraud, it is surely Herman Melville's 1857 novel *The Confidence Man*. This "parable of the market economy" (Mihm 2007: 4) follows the title character over the course of a day (April Fool's Day, of course) as he plies his trade on a steamboat cruising down the Mississippi River—his trade being the extraction of money from his fellow passengers on pretexts ranging from donations to loans. The confidence man succeeds, Melville writes, not just because of his skill, but because the boat (much like the market as conceived in economic theory) is "always full of strangers, [and] she continually, in some degree, adds to, or replaces them with strangers still more strange" (Melville [1857] 2010: 8). Amidst this continual turnover of actors, the swindler alone remains a steady presence, and fraud is the sole constant. No wonder then that one sociologist recently called for a reevaluation of "the major significance of the con man in the establishment of society" (Ogino 2007: 96).

As Melville's story suggests, the sociology of fraud is inseparable from the sociology of trust and confidence (see Swedberg, this volume). Indeed, the history of finance tells us that confidence is the common underpinning of both "legitimate" capitalism and fraudulent activity. Reviewing the nearly 300 years that have elapsed between the first large-scale financial fraud in history—the British South Sea Bubble of 1720—and the contemporary financial crisis (marked by the machinations of white-collar confidence men like Bernard Madoff), we can appreciate how one historian concluded that "At its core, capitalism was little more than a confidence game," a known fraud tolerated because "as long as confidence flourished, even the most far-fetched speculations could get off the ground, [and] wealth would increase" (Mihm 2007: 11).

In this system, fraud and faith flourish together. As a result, the lines between legal and illegal acts, criminals and honest dealers, become dangerously blurred, raising troubling questions about the foundations of capitalism itself. In contemporary capitalist societies, this inevitably leads to further questions about social structure, from institutions, through interactions, and the very nature of identity itself. Indeed, one could

conclude from a review of social theory over the past half-century that fraud permeates social life at every level. In place of individual authenticity, we have simulacrum (Baudrillard 1994); in place of interpersonal intimacy, impression management (Goffman 1959); and in place of trusted institutions, we find structures whose relationship to fraud is ambivalent at best and often frankly complicit (Galbraith 2004; Tillman and Pontell 1995). Each of these three conceptual dimensions of fraud will be examined in detail below. But first, a discussion of the legal and social scientific definitions of financial fraud is in order.

DEFINITION OF FINANCIAL FRAUD

Considered against the background of other types of crime and social deviance, acts of fraud distinguish themselves by the ways they “blend imperceptibly into legitimate ones” (Shover, Coffey, and Sanders 2004: 73). In other words, for fraud to occur, it must be difficult to recognize as such. Furthermore, fraud varies widely in its presentation; American law recognizes at least 24 different types, ranging from mail and securities fraud to fraud on the court (Garner 1999: 670–2). The world of finance is particularly vulnerable to fraud because of the “controlling fact” of uncertainty, which means that there are “ample predictions but no firm knowledge” (Galbraith 2004: 35). Con artists and other perpetrators take advantage of this uncertainty, exploiting individual emotions (such as hope, fear, shame, and greed), as well as relationships of trust, and the opportunities afforded by institutions.

Since fraud is widely underreported, it is difficult to determine its true scope and cost, but annual losses due to fraud in the US are estimated at \$40 billion to \$100 billion (Langenderfer and Shimp 2001; Titus, Heinzelmann, and Boyle 1995). This includes an average loss of \$22,175 for each of the millions of Americans who fall prey to investment fraud—many of whom are repeat victims (Titus and Gover 2001). In the UK, financial fraud is thought to cost the economy between £13 and £30 billion per year (Fisher 2010). These estimates include fraud at many levels, from institutional corruption to individual swindles. While financial scams continue to take the form of the face-to-face confidence tricks envisioned by Melville (and theorized by Goffman 1952), technology and complex organizational structures are increasingly used to perpetrate fraud that is “nonconfrontational . . . and can be carried out over long distance” (Shover, Coffey, and Sanders 2004: 61). The complexity and changing face of the phenomenon underscores the need to define it clearly.

In common parlance, fraud connotes the calculated use of dishonesty to gain an unfair advantage, often exploiting a position of trust in the process—thus the connection to confidence. The *Oxford English Dictionary* (2nd edn, 1989) defines fraud simply as “criminal deception.” But in the sparse sociological literature on the phenomenon, the definition employed is more nuanced, emphasizing the camouflage of normality that makes fraud successful. For example, one recent study of telemarketing scams notes that

“Fraud is committed when misrepresentation or deception is used to secure unfair or unlawful gain, *typically by creating and exploiting the appearance of a routine transaction*” (Shover, Coffey, and Sanders 2004: 60, emphasis added). The sociological perspective closely resembles the American legal stance, which observes that fraud “resembles theft in that both involve some sort of illegal taking,” but with the additional element of false pretenses; because creating the illusion of trust and normality requires more advance planning than theft, fraud is punished more severely as a result (Lehman and Phelps 2004: 4–353).

However, not all forms of deception are fraud. Indeed, many forms of deception are embraced as diversion. This includes tabloid-style gossip and rumors “too good to be false” (Fine 2009: 186), along with *trompe l’oeil* images, magic tricks, and other forms of art and entertainment. The common denominator in such cases is the consent of the audience, and their will to believe—making for “authorized deception” (Harrington 2009: 5) rather than fraud. This means that many erroneous statements of belief and exaggerations in the financial arena—such as “the Dow Jones Industrial Average will reach 100,000 by the end of the year”—do not meet the legal or commonplace definitions of fraud.

In American law, deception becomes fraud *only* when all of the following conditions apply: a) there is a false statement of fact (or the omission of a fact) that is directly related to the transaction and directly affects the actions of the victim; b) the speaker must know that the statement is untrue (or that the omission is significant); c) the speaker must intend to deceive the victim; d) the victim must have good reason to trust the truth and completeness of the statement; and e) the victim must be injured or end up in a worse position as a result of the false statement or omission (Lehman and Phelps 2004: 4–353). This narrows the legal range of financial fraud to two basic forms: material misrepresentations and omissions, also known as “deception through non-disclosure” (Cronin, Evansburg, and Garfinkel-Huff 2001: 1296), and insider trading. The former category of offense covers many of the financial fraud scandals of the early twenty-first century, such as Enron and WorldCom, in which there was “a deliberate misstatement of the firm’s results, either through altered financial reports or a misleading news release; such an effort increases the odds that a casual glance at the firm’s results will lead investors to think the firm is in good shape” (Povel, Singh, and Winton 2007: 1228). The goals of this type of fraud include enhancing an organization’s ability to raise capital, or avoiding regulation or a decline in share prices.

Insider trading is more often geared toward individual rather than organization gains and involves “trading on confidential information that a defendant uses for his or her own gain in breach of fiduciary, contractual or similar obligation to the owner or rightful possessor of the information” (Cronin, Evansburg, and Garfinkel-Huff 2001: 1296). This was a particularly high-profile form of financial fraud during the merger and acquisition wave of the 1980s, but it remains common and tightly connected with other forms of corporate fraud. For example, Enron CEO Ken Lay was accused of using his privileged information about the accounting fraud (“material misrepresentations and omissions”) occurring at the firm to sell \$70 million worth of

his shares before the company's true financial deterioration became public knowledge (Johnson 2004).

As the definition of insider trading suggests, the legal recognition and prosecution of fraud hinges on the identity of the parties, as well as the nature and context of their interaction. A given event may or may not be fraud, depending on who was involved, the properties of their interaction, and the organizational and institutional setting in which it took place. For example, a claim such as "this investment will double in value within 24 hours" would not ordinarily be considered fraud because it is so far-fetched as to be implausible to most people; but if the victim is illiterate or financially desperate, American courts have defined such statements as fraud in cases where the speaker knew and sought to take advantage of the victim's vulnerability. By the same token, the identity of the speaker bears heavily on whether his or her statements can be considered fraud. Clergy, lawyers, and physicians are subject to particular scrutiny in this area, both because they hold positions of trust and because they are assumed to have expert knowledge on which others can rely. This is particularly common in finance, where the "fiduciary" role (Harrington Forthcoming) of stockbrokers, trustees, and corporate officers presents many opportunities to exploit trust and expert knowledge to unfair advantage. It is of some sociological interest here to note that the UK definition of fraud, while similar to that in the US in its reference to false representations and omissions, differs by placing a much greater emphasis on fraud through "abuse of position," and totally eliminates the requirement that a gain or loss actually occur; the central issue is rather the interaction between the parties and the intent of the accused to take unfair advantage of their relationship (CPS 2008).

As these observations suggest, fraud is essentially a crime of interaction, in that a given act, statement, or omission of fact is not *inherently* fraudulent, but only becomes so in certain types of interpersonal transactions. Though the identities of the parties to the transaction play a significant part in the process, the interaction context determines whether those identities are relevant. For example, a priest interacting with a parishioner during confession is subject to different role expectations than he is if the two meet in line at the grocery store. A stockbroker's fiduciary obligations bind him or her in the context of business interactions with clients, but not in a dispute with a neighbor over a noisy party—even if that neighbor is the client!

Empirical research suggests that some interaction contexts lend themselves more readily to fraud than others. In general, the telephone remains the preferred medium for conveying false or misleading information, far exceeding instances in online or face-to-face contexts (Hancock 2009); this may be because telephone conversations require less control of nonverbal cues like facial expression (which might give away the ruse in face-to-face settings), and unlike e-mail or other online communications, leave no paper trail. But the Internet has undoubtedly become the leading edge of growth for financial fraud, whether in the form of the ubiquitous Nigerian bank wire scams, or of "pump and dump" schemes, in which false information favorable to a stock are spread through Internet chat rooms or mass emails, causing prices to rise, at which point the perpetrators "cash in" by selling their shares (Walker and Levine 2001). More recently, social

networking applications like Facebook have been used as a vehicle for financial scams: by creating fraudulent profiles (usually purporting to belong to an attractive young woman), con artists “friend” potential victims, gaining access to their personal information and contact details. Some collection agencies have adopted a similar strategy, using fraudulent Facebook profiles to “friend” debtors and track them down in person based on status updates and other data (Popken 2009).

Like some technologies, certain organizations, institutions, and industries are deemed “criminogenic” (Needleman and Needleman 1979; Vaughan 2007) for the ways in which they structurally facilitate or even promote fraud. The waves of financial fraud that have hit the markets in the early years of the twenty-first century have even given rise to a new theoretical orientation: the “criminogenic markets approach” (Tillman and Indergaard 2007: 482). This analytical framework posits that deregulation and the emergence of novel financial tools—poorly understood by regulators, and sometimes even by finance professionals themselves—have created unprecedented complexity and opportunities for fraud on a global scale. Organizations themselves have become disposable, mere weapons in schemes that transcend the boundaries long used to determine legal accountability, such as the firm and even the nation-state. Examples include the hedge fund industry—accused of packing and selling fraudulent subprime mortgage investments—and the global institution of offshore banking, perpetually under scrutiny as a facilitator of international tax fraud and other criminal activity. There is even evidence supporting an imitative model of fraud within the financial industry, suggesting that when one firm is suspected of prospering through fraudulent practices, competitors follow suit (Schiesel 2002).

THREE FACETS OF FRAUD

Identity

Just as financial fraud itself depends for its success on being mistaken for routine business practices, perpetrators succeed to the extent they can “pass” as honest and trustworthy individuals. Historically, swindlers have exploited positions ranging from high government office to ethnic affiliation to gain the confidence (and cash) of victims. The strategic use of social identity to commit financial crimes is most obvious in cases of “affinity fraud,” where ethnic, religious, or professional similarity is used as “a shorthand way of knowing who to trust” (NASAA 2010). Thus, a classic form of financial fraud—the pyramid scheme—was born when Charles Ponzi began preying on his fellow Italian immigrants in Boston’s South End just after World War I (Darby 1998). Eighty years later, Bernard Madoff “relied on the Jewish community, in an almost tribal way,” using his impeccable record of support for Jewish charities to attract assets for his very own “\$50 billion Ponzi scheme” (Hamilton and Reckard 2008; Silverstein 2008)—neatly illustrating John Kenneth Galbraith’s observation that “the man who is

admired for the ingenuity of his larceny is almost always rediscovering some earlier form of fraud” (1979: 75).

The cases of Ponzi and Madoff also exemplify an important sociological insight: that the strategic deployment and manipulation of identity—also known as “impression management” (Goffman 1959)—can be used to create a “fraudulent social reality” (Young 1990: 103). As dramaturgical theory shows, the line between self-presentation and confidence games can be very fine indeed. The ambiguity is extremely useful for those who commit fraud, affording them a credible claim to normalcy (Goode 2002) and allowing them to distance themselves from the stigma of deviance.

This is particularly true in contemporary capitalist societies, which place enormous value on persuasion, salesmanship, and winning. In this context, impression management designed to manipulate others for financial gain—such as intentionally misrepresenting one’s work-related identity to get a job or win a promotion—is commonplace. One recent study found that 81 percent of individuals lie about their qualifications during job interviews (Weiss and Feldman 2006), while others show that résumé fraud (also known as résumé “padding” or “doctoring”) is “institutionalized” and even “mainstream” (Wexler 2006: 139). The commonplace quality of lying in everyday life (DePaulo and Kashy 1998; Feldman, Forrest, and Happ 2000; Harrington 2009) makes it easy to morally neutralize fraud (Sykes and Matza 1957), particularly in the context of business transactions, where perpetrators can draw on set phrases like “caveat emptor” or “past results are no guarantee of future performance” to deflect stigma from themselves and onto their victims. So while sociological research once suggested that fraud is committed primarily by people on the margins of society—such as drifters and those with “personality disorders” (Maurer 1940)—empirical data suggest that it would be more accurate to observe “how ‘normal’ it is to be a confidence man or swindler” (Blum 1972: 14).

For example, in a study of individuals serving prison time for telemarketing fraud, Shover, Coffey, and Sanders (2004) showed how perpetrators morally neutralize (Sykes and Matza 1957) their acts by positioning themselves on the spectrum of normal, even praiseworthy, commercial behavior. Common identity reframing tactics included defining themselves as champions of “free enterprise,” highly successful salesmen, and even as the victims of Federal persecution. Furthermore, committing fraud was experienced by the perpetrators not just as financially rewarding, but as “enhancing the telemarketers’ positive definition of self” (Shover, Coffey and Sanders 2004: 72). By “putting one over” on their customers and winning the power game of persuasion, they enjoyed what social psychologists call “duping delight” (Ekman 1988). Telemarketing fraud provided as much of a boost to the perpetrators’ subjective sense of self-worth as it did to their net worth.

To the people they defrauded, these telemarketers assigned identities designed to imply culpability: customers were not exploited victims, but rather “greedy, ignorant or incapable” (Shover, Coffey, and Sanders 2004: 70). That is, the perpetrators not only created false (trustworthy) identities for themselves, but offloaded the stigma associated with their own deviant (and illegal) behavior onto their customers; this is what is meant

by describing impression management as a kind of fraud (Young 1990). The victims not only lost their money, but their social personas, or “fronts”—their public identities as competent adults (Goffman 1959). Being conned destroys the self symbolically, rendering victims “socially dead” (Goffman 1952: 460). Empirical research suggests that those who have lost money in this way are surprisingly willing to accept these identities, describing themselves as “greedy,” “delusional,” and “money whores” (Harrington 2008: 153). Given that “there is no crime in the cynical American calendar more humiliating than to be a sucker” (Lerner 1949), making these pejoratives part of one’s social identity is apparently preferable to the even greater shame of appearing to be a helpless, naïve victim.

Interaction

Fraud is a crime of interaction not just because it requires both a deceiver and a deceived, but because it depends for its effectiveness on the nature of the relationship between the two parties. For example, fraud attempts are more likely to succeed when victims know (or know of) the perpetrator, according to the national Fraud Victimization Survey; this is significant, since the incidence of fraud in the US is “very common” and rising (Titus, Heinzlmann, and Boyle 1995: 65). The relational aspect of fraud is acknowledged in the United States criminal code, which metes out harsher punishment to perpetrators who take advantage of particularly vulnerable victims, such as cancer patients, who may be vulnerable to scams involving sales of new medical treatments or stock in companies that claim to have found a cure (USSC 2009).

Fraud holds particular interest for sociologists since it exposes the multiple facets, both positive and negative, of social networks. Research on small groups (Harrington and Fine 2000, 2006) as well as studies of social capital (Putnam 2000; Harrington 2001) have typically focused on the *benefits* of interpersonal relationships for everything from getting a job (Granovetter [1974] 1995) to accessing start-up capital for entrepreneurial ventures (Gaston and Bell 1988). At the same time, networks and social ties have a dark side (Portes and Sensenbrenner 1993) that serves to “increase opportunities for deceit, deviance, and misconduct” (Baker and Faulkner 2004: 92).

Trust and interpersonal interactions are particularly important in the misuses of social networks. Even in societies with well-developed institutional structures, individuals report placing more trust in local, face-to-face sources than in formal organizations (Rowan 2009). Thus, when individuals invest in the stock market, their choices are influenced primarily by the behavior and recommendations of friends, business associates, and neighbors rather than information from institutional sources, such as brokerage firms, analysts, and financial news outlets (Shiller and Pound 1989; Katona 1975). This reliance on interpersonal interactions for financial information appears to become even more intense when investments (or financial markets generally) perform poorly (Harrington 2008; Baker and Faulkner 2003). The phenomenon occurs among financial professionals as well as among amateurs, and can evolve from a perfectly legal reliance

on advice and information from friends and associates into illegal activities such as insider trading (Cronin, Evansburg, and Garfinkel-Huff 2001) and other financial crimes.

Some interaction settings may be “criminogenic” simply because of the easy opportunities they present to misuse interpersonal ties and hide instances of misconduct within a myriad of legitimate interactions (Needleman and Needleman 1979). As Granovetter (1985: 491) has observed, “The trust engendered by personal relations presents, by its very existence, enhanced opportunity for malfeasance.” Among other things, fraud may be facilitated by the need and willingness of most people to believe that others are trustworthy until given reason for doubt (Fine 2009). Similarly, fraud benefits from “accusatory reluctance” (O’Sullivan 2009)—the social inhibition many people feel in voicing doubts about the honesty and motivations of others.

By the same token, interaction settings may also create vulnerability to financial fraud through phenomena unique to groups, such as imitation and status competition (Frank 1985). These dynamics seem to have motivated “rogue trader” Jérôme Kerviel, whose fraudulent derivatives trades cost his employer—Société Générale in Paris—an estimated \$7 billion; this was considered the largest bank fraud in history until the emergence of the Madoff scandal. Kerviel’s defense strategy consisted mainly of pointing out to the court that he was simply imitating the trading behavior of other members of his workgroup, as part of the competition for bonuses and promotions: “It wasn’t me who invented these techniques—others did it, too” (Clark and Bennhold 2010). A similar fraud-facilitating group dynamic may be “emotional contagion” (Hatfield, Cacioppo, and Rapson 1994; Pugh 2001), in which the emotions of some individuals stimulate others to feel and express similar emotions, which are then reflected back to the instigators with escalating intensity. This phenomenon seems to be the intuition behind John Kenneth Galbraith’s well-known definition of financial manias as “the mass escape from sanity by people in pursuit of profit” (1990: 52).

Financial fraud operates on similar dynamics to those of financial bubbles. Although a bubble may not involve any fraud, it does involve interaction processes and the expectation of profit from a future sale. Confidence is the key concept linking fraud with speculative manias, as explained in a history of counterfeit money in the early development of the United States’ economy:

[V]alue was something that materialized and became tangible when the note was exchanged, when one person put confidence in the note of another. Only then, at that instant, would an intrinsically worthless piece of paper come to mean something more. Counterfeiters grasped this essential truth, which applied not only to bank notes, but also to the emergent market economy as a whole. (Mihm 2007: 10)

In a remark eerily prescient when viewed in light of the contemporary economic crisis, the same study points out that counterfeits—like stocks, collateralized debt obligations, and other financial instruments implicated in the 2008 global market meltdown—were just “slips of paper that passed from hand to hand, affirming a common confidence in future prosperity” (Mihm 2007: 28). In financial markets, we have seen recently that the

erosion of confidence, of the kind that occurs in the aftermath of fraud, brings interaction to a halt. Or as Alan Greenspan—then-Chairman of the Federal Reserve Board—put it in a 1999 commencement address at Harvard College, “If a significant number of business people violated the trust upon which our interactions are based, our court system and our economy would be swamped into immobility.”

Institutions

While individual confidence men like Bernard Madoff grab the lion’s share of the news coverage devoted to financial fraud, the frauds that arguably present the greatest dangers to economic and political stability are essentially faceless, in the sense of not being reducible to the behavior of identifiable actors (Galbraith 2004). Institutional fraud—from political “machines” that thrive on bribery and kickbacks, to corporate cultures that use rigged bidding practices and falsified accounts—puts the whole financial system at risk. This is because institutions provide routines on which expectations can be based (Jepperson 1991), and expectations are the basis of economic action (Keynes [1936] 1965). At issue is how social actors establish conventions about actions, motives, and interactions such that exchange can take place; cooperation, competition, and valuation are based on these expectations, all of which are necessary preconditions to market order (Stark 2009).

Thus, when economic institutions are disrupted by fraud, the whole financial system can break down. Market order—a central concern for economic sociologists (Beckert 2009) as it is for financial practitioners—becomes impossible. Events like the subprime mortgage crisis, aided and abetted by the widespread use of falsified documents in several major financial institutions (Henning 2010), have illustrated this problem all too vividly. But whole institutions are difficult to hold accountable under a legal system designed to punish crime at the individual (and sometimes group) level of analysis (Laufer and Strudler 2000).

While the law is still playing catch-up with this reality (Walker and Levine 2001), sociological inquiry has been at the forefront of addressing the level of analysis problem, with decades of research showing that whole industries promote and facilitate fraud (e.g., Denzin’s 1977 study of the American liquor industry and the Needleman’s 1979 study of the securities industry), and that the financial markets as a whole may be irretrievably “criminogenic” (Tillman and Indergaard 2007). Institutional environments can encourage fraud by presenting “extremely tempting structural conditions—high incentives and opportunities, coupled with low risks” (Needleman and Needleman 1979: 521). These structural conditions include institutional size, complexity, and legitimacy: the first two factors make it difficult to locate accountability for actions, or easy to hide malfeasance; and the third provides cover, in the sense of placing some institutions above suspicion or making them subject to low regulatory oversight.

The legitimacy and public trust enjoyed by brokerage firm Merrill Lynch, which was known as “a symbol of middle-class investing” (Scheiber 2002: 18), helped it

defraud its investors for much of the 1990s. In the analyses of Merrill economists, which were intended to help customers decide whether to buy, sell, or hold an investment, “stocks that were publicly said to represent a sound investment were in private emails [within Merrill] described as ‘a piece of shit’ and a ‘piece of crap’” (Swedberg 2005: 191). When these abuses of Merrill’s fiduciary role came to light, the firm agreed to pay \$100 million in damages, but without admitting any wrongdoing (Levitt 2002: 82).

However, the dissemination of intentionally misleading analysts’ reports, along with other forms of financial fraud, is thought to be pervasive within the financial industry (Galbraith 2004). This is true even in financial organizations closely connected to the government. For example, even before the subprime mortgage crisis, Fannie Mae—the congressionally chartered Federal National Mortgage Association, which is the largest mortgage finance lender in the United States—was found by the Securities and Exchange Commission (SEC) to have committed “extensive financial fraud” by doctoring accounting statements over a period of six years to ensure the maximum bonus payouts for its chief executives (Day 2006). A few months after paying a \$400 million penalty for those offenses, the agency was once again under investigation by the FBI for pressuring and possibly bribing securities analysts to inflate ratings on mortgage-backed securities—a key component in precipitating the recent global economic crisis (Bawden 2008).

This pattern of fraud and betrayal of public trust by financial institutions linked to the national government is nothing new. Before the Fannie Mae investigations, there was the meltdown of the savings and loan (S&L) industry, which had enjoyed considerable public trust for generations (Tillman and Pontell 1995). Even as government oversight of the S&Ls shrank, creating more opportunities for fraud, the institutions were still considered by many to enjoy the imprimatur of the US government, since all deposits were federally insured. But a combination of size, complexity, and legitimacy shielded the industry for years before its systemic corruption was uncovered.

The historical roots of fraud in government-linked institutions go all the way back to 1720, and the event known as the world’s first great financial fraud: the South Sea Bubble in England. The South Sea Bubble was actually the product of several frauds linked together, “corruption on an audacious scale” (Reed 1999: 38). The first was the establishment of a trading company that was never intended to trade; ostensibly the South Sea Company was established on the basis of holding exclusive rights to trade English goods with the gold-rich Spanish colonies in the Americas. In fact, those lucrative trading rights never existed, and the Company never sent out a single ship, because the real purpose of the scheme was to get the holders of some £10 million in short-term government debt to exchange their notes for South Sea stock, thereby privatizing the national debt. The shares’ value *appeared* to be guaranteed, as the short-term debt had been, by the Crown: the South Sea Company had, after all, been created by an act of parliament, and the King himself made a public display of investing £100,000 of his own money in the venture. What the investing public did not know was that the South Sea Company was the brainchild of a con artist (John Blunt) whose previous experience included running

lotteries, and that members of parliament had been bribed to “overlook the fact that the South Sea Company didn’t have a dime of assets” (Werner 2003: D17). Thus, when the Company stock suddenly ceased to sell, the market crashed, bankrupting many whose investments had been used to refill the royal coffers. The state’s response to this destruction involved still more fraud: parliamentary leaders suppressed evidence, and summarily cancelled or “adjusted” the losses of some favored investors “so that imaginary wealth could be sucked out of the system” (Carswell 2002).

This historical case illustrates two of the most distinctive aspects of modern financial fraud. First, organizations and institutions are not simply *contexts* in which fraud occurs, but can also be *purpose-built to commit fraud*. The South Sea Bubble was a “pre-planned fraud” (Levi 1981), whose contemporary descendants include the infamous “boiler room” securities firm—“a business created and operated for the sole purpose of defrauding investors” (Baker and Faulkner 2004: 92). These empirical data run contrary to the tenets of several mainstream sociological theories: the theories posit survival as the primary goal of organizational behavior (e.g., Pfeffer 1990; Aldrich and Pfeffer 1976), but the data suggest that for those engaged in fraud, “the long-term survival of their institution was often unimportant” (Tillman and Pontell 1995: 1458) as long as it accomplished its short-term goals of generating financial gains. This notion of organizations, institutions, or even whole industries being disposable by design raises troubling issues for sociological theory, as well as for finance and public policy in practice.

The second pattern in financial fraud that has remained consistent from the earliest incidents of the phenomenon until the present day is the ambivalent role of government institutions. Since 1720, we have seen repeatedly that the very entities charged with guarding against and punishing fraud are implicated in its creation and perpetuation. For example, historians have documented the essential role that counterfeiting paper money played in the economic development of the United States—a role recognized by government and banks in the early 1800s, when as much as 10 percent of the nation’s currency was fake. Thus, while the institutions of law and order sought to combat counterfeiting, they also tolerated it in many quarters, recognizing that all paper currency was essentially “confidence money” and that “the activities of banking, counterfeiting and speculative capitalism coexisted on a continuum” (Mihm 2007: 16).

Recently, a similar tension between governments as fraud-generators and fraud-fighters has developed in the realm of offshore banking. For instance, many well-known financial centers, such as Jersey and the Cayman Islands, originally entered the banking business at the behest and for the benefit of onshore governments (Hampton and Christensen 2002). This included providing services vital to legitimate economic development, such as facilitating the creation of the Euromarket—trade between the US and Europe that would not have been possible onshore due to restrictions on exchange rates and currency reserves (Palan 1998). Now, many of these offshore financial centers are under investigation (and threat of exclusion from global banking networks) by the same onshore governments that sponsored their development, which now accuse them of being havens for tax evasion, money laundering, and other forms of financial fraud (Van Fossen 2003).

DISCUSSION: THE FUTURE OF FRAUD

As Simmel ([1908] 1950) observed over a century ago, action is not possible without confidence. Economic action, in particular, depends upon confidence: investors and other market actors need to know that they can form reasonably accurate expectations about the future based on the present and past (Barbalet 2001; Keynes [1936] 1965). This is one reason the US Federal Reserve Board (FRB) tracks consumer confidence data so closely. Widespread evidence of fraud, from the falsified accounting used by Enron and Worldcom (Patsuris 2002) to the exploitation of clients by trusted fiduciary agents like Bernard Madoff and Goldman Sachs (Chan and Story 2010), disrupts the ability to form expectations. Lack of confidence eventually leaves the financial and legal system “swamped into immobility” (Greenspan 1999). Or, as Melville’s confidence man put it, “Confidence is the indispensable basis of all sorts of business transactions. Without it, commerce between man and man, as between country and country, would, like a watch, run down and stop” (Melville [1857] 2010: 172). For those of us who have recently witnessed the international financial machine “run down and stop,” the prescience of the confidence man is chilling. As financial history going back to the South Sea Bubble suggests, fraud’s destructive power is enduring, altering not just the trajectory of individual lives but also social relations and institutions across generations.

Recent research suggests that the most common regulatory responses to financial fraud—tougher sanctions, along with more rigorous standards for monitoring and transparency—will not work. For example, as Povel, Singh, and Winton (2007: 1221) point out, “throughout the 1990s, improved computing and communication technologies greatly reduced investors’ costs of examining firms’ prospects, yet at the end of the decade . . . a wave of frauds occurred.” Even more troubling, recent regulatory efforts like the Sarbanes–Oxley Bill, conceived in response to the accounting frauds of the early twenty-first century, have been widely criticized as having “fixed non-existing problems” (Brown 2006: 309) while failing to address critical systemic issues (Soederberg 2008). Most ominous of all, there is evidence that intensified regulation “can actually increase incentives to commit fraud” (Povel, Singh, and Winton 2007: 1220).

In recent Congressional testimony about the underlying causes of the current economic crisis, the US attorney general acknowledged the role of pervasive, long-term fraud in precipitating the collapse of markets worldwide (Mikkelsen 2009). His chief recommendation for addressing the crisis was the creation of a “financial fraud task force,” modeled on the 9/11 Commission. Unlike previous Federal investigations, which focused on specific categories or instances of fraud (such as those involving mortgage-backed securities), the new task force would provide “a more comprehensive view,” suggesting that elected officials recognize that the problem is chronic and systemic, rather than acute and localized.

This puts American policymakers on the same page with many economic historians, who argue that fraud—far from being an anomaly or a disease state—is in fact a neces-

sary condition of capitalism. Wolff, for example, argues from Marx that “obfuscations...are the necessary and characteristic mode in which capitalist social relations *misrepresent* themselves” (1988: 42–3, emphasis in original). Others, drawing on evidence stretching back to the early days of global trade, point out that corporate fraud has for centuries been both “transparent” and “accepted” (Galbraith 2004: 24–6; see also Chancellor 2000)—literally part of the cost of doing business. As British novelist Anthony Trollope observed in 1856, when English law re-legalized the joint stock company after a long hiatus following the South Sea Bubble, “a certain class of dishonesty, dishonesty magnificent in its proportions, and climbing into high places, has become at the same time so rampant and so splendid that men and women will be taught to feel that dishonesty, if it can become splendid, will cease to be abominable” ([1883] 1999: 354). This may explain why, despite a long history of frauds and financial disasters, capitalism in the Western world remains largely intact as a system of economic and political organization. Perhaps the negative moral valence of fraud has been overshadowed by its splendor. Or perhaps, like John Maynard Keynes, himself a highly influential critic of capitalism, survivors of financial frauds ultimately “could not countenance any other social system” (Dowd 1993: 33).

It remains to be seen how the global order will be reshaped by the present crisis and regulatory responses. In the meantime, there are a number of open questions about fraud for the sociology of finance to consider. One empirical issue (system robustness), one theoretical question (the authority to define fraud), and one methodological problem (data adequacy) deserve particular attention in future research.

Robustness—How much fraud can a financial system absorb before it breaks down? Empirical research suggests that fraud is pervasive in white-collar settings such as the financial industry (Tillman and Indergaard 2007), and yet systemic breakdowns are not an everyday occurrence. It may be that some amount of fraud is tolerable without threatening the whole financial system; indeed, some research even casts fraud in a positive light. For example, widespread counterfeiting of US currency in early nineteenth-century America was accepted as a way of easing the money supply and facilitating national economic expansion: “Many people in the business of banking viewed counterfeiting as a small price to pay for a system of money creation governed not by the edicts of a central bank or the fiscal arm of the state, but by insatiable private demand” (Mihm 2007: 15).

Recent work on deception in animal systems suggests that false signaling occurs in about 15 percent of cases: that is, about one time in seven, a bird or a chimp purposefully sends out a false danger signal, causing other members of the group to scatter and reducing competition for some valued, scarce resource, such as a bit of food or a mating opportunity (Gell-Mann 2009). There seemed to be a threshold in place, below which the animal system could continue to function without revising its warning system and without removing the false signaler from the group. Could there be a similar threshold model at work within human systems? This question may provide a useful starting point for examining the robustness of financial systems to fraud.

Definitional authority—Financial fraud is a social construction. However abstract the concept, its definition has significant consequences for markets, organizations, and

individuals. As a phenomenon, it depends not only upon the identities and relationship of the transaction parties—whether one of them was particularly vulnerable, for example, or another held a position of special trust and expertise—but also on the venue in which the transaction occurs. What qualifies as fraud in one setting might be called “art” or “entertainment” in another.

Adding an additional layer of complexity is the issue of who or what is invested with the authority to define fraud. Legally, that role belongs to judges and legislators, but, as comparative studies of financial fraud cases have shown, there are wide divergences in interpretation and application of the laws, even within the same jurisdiction (e.g., Pritchard and Sale 2005). The conditions are reminiscent of the well-known quip by major league baseball umpire Bill Klem, who is said to have responded to a player’s query about whether a ball was fair or foul by saying, “Sonny, it ain’t nothin’ til I call it.”

In practice, this leads to troubling ambiguities for financial actors, making it difficult to form expectations or to determine legal versus illegal lines of action within markets. This results in what Galbraith calls “innocent fraud,” in which systemic financial deception and exploitation are obscured by “the pecuniary and political pressures and fashions of the time, [so that] economic and political systems cultivate their own version of the truth. This last has no necessary relation to reality . . . what is convenient to believe is greatly preferred” (2004: 2).

Data adequacy—Selection bias presents a major challenge for the sociological study of financial fraud. As with all work on deceptive behavior, research on fraud is limited to instances where the perpetrators have gotten caught—potentially limiting the range of frauds available for study to the most “poor-quality and easily-detectable ones” (O’Sullivan 2009: 82). Since it would violate contemporary research ethics to conduct fraud in order to study it, scholars have been restricted to cases that are accessible through public records (e.g., Baker and Faulkner 2004; Shover, Coffey, and Sanders 2004). This uncertainty about the adequacy of the available data on fraud calls into the question the adequacy of our models—an issue that future research needs to acknowledge and, if possible, address.

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