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## **The Madoff Scandal Exposes Government Failure** **by Sheldon Richman**

A rule we can rely on to be unfailingly applied is this: No matter how much the government controls the economic system, any problem will be blamed on whatever small zone of freedom that remains. This of course is evidence of a rigged game. The government can't possibly monitor and regulate absolutely every transaction that takes place in a country. Stalin and Hitler couldn't do it by a long shot. So anything that displeases the ruling regime can easily be laid at the doorstep of freedom and be used as an excuse for stamping out whatever traces of liberty still exist.

In that light, the common reaction to the Bernard Madoff \$50 billion financial scam was wholly expected. As *Los Angeles Times* columnist Tim Rutten wrote,

The lesson is one that becomes clearer with each excruciating turn of the Wall Street screw. The long, bipartisan experiment with financial deregulation has failed utterly. The argument that a return to rigorous oversight will somehow stifle Wall Street's "creativity" is no longer convincing. Whatever its theoretical costs, regulation is dramatically cheaper than intervention. And absolutist insistence on the superiority of "individual choice" and "free markets" now is exposed as so much vacant rhetoric. Any system that permits a scam artist like Madoff to deceive not just widows and orphans but also sophisticated investors, like Fairfield Greenwich Group's Walter Noel and Hollywood's Jeffrey Katzenberg, isn't a market at all; it's a shooting gallery.

Similar examples can be turned up with a quick Google search.

Rutten's last sentence is a tip-off, however, that something is wrong with this outlook. Financial regulation is usually proposed to protect the unsophisticated. People knowledgeable about finance and securities presumably can take care of themselves. The underlying philosophy is that those with little knowledge about such complex matters ought to be able to invest as safely

as people who spend their time studying such matters. What makes the Madoff scandal so noteworthy is that the most sophisticated types were taken in, even though several experts sounded alarms about Madoff's operation over the years.

The other thing to note about Rutten's position is that there has been no relevant financial deregulation to speak of. In fact, since Enron's collapse, regulation has intensified and the regulatory budget has grown. The SEC already requires investment and hedge-fund managers handling assets of more than \$100 million to file quarterly reports. Under prodding from outsiders, the SEC looked at Madoff's operation more than once but found no major problems.

Moreover, Madoff's alleged crimes involve fraud. "Isn't fraud already illegal?" asks Phillip Goldstein of Bulldog Investors. What protection would regulation add?

Contrary to Rutten, whose prejudice against "individual choice" and "free markets" is palpable, these two facts — sophisticated victims and pervasive regulation — demonstrate that the Madoff scheme represents the failure not of the free market (which did not exist) but rather of government regulation.

How can that be?

### **A false sense of security**

Begin with the obvious: a false sense of security is worse than none at all. When people believe government is protecting them from fraudulent financial services, they are more vulnerable to scams than if they know they have to protect themselves. The government's huge regulatory apparatus broadcasts one unmistakable subliminal message: Have no fear because Big Brother is watching over you. Is it any wonder that people are less wary than they would be if they did not believe that?

As long as government plays a regulatory role — or people believe it does — they will assume that key activities are being monitored. And even when an activity is known to be unregulated, the implication is that if regulation were needed, the government would be doing it. Why else did worldly investors fall for Madoff's self-described "giant Ponzi scheme"?

Comments in the wake of the scandal demonstrate the point. For example, an official with Commerzbank AG states,

There needs to be greater oversight of the fiduciary roles where there are clear conflicts of interest as in the case of Madoff. Investment advisory and custody roles have to be segregated. This is critical to avoid frauds. To reduce investment risks, we need greater disclosure of the magnitude of leverage.

But why would such disclosures need to be mandated by government regulation? Why would protection against conflicts of interest have to be provided by bureaucrats? Or, to put it

another way, why aren't sophisticated investors demanding such information simply to protect themselves? Can it be that experienced financial participants hand over millions of dollars willy-nilly to the first person who offers to handle their money?

Another example comes from Mary Schapiro, Barack Obama's choice for SEC chief and, like Madoff, a former NASDAQ official. "We found inadequate risk disclosure and touting, such as how the fund can beat the market with less volatility and promises about expected returns."

But again, why weren't savvy potential investors demanding better risk disclosure?

Their failure to do so makes no sense — unless the regulatory state had lulled the investors into believing someone else was watching out for them. There can be no other explanation, in which case regulation makes everyone a potential victim.

### **Security in a free market**

Advocates of regulation may reply that even seasoned investors may not be able to recognize inadequate disclosure of key factors. Perhaps. But if so, there would be a market for independent investment information, as there is for many other kinds of information. The division of labor would make up for the investors' own lack of knowledge. What they need to protect themselves is not first-hand information, but wariness that they could be taken advantage of. Government regulation reduces that wariness — to the detriment of everyone.

Moreover, what makes anyone think government regulators are better able to spot fraud than potential investors and professional watchdogs?

As an aside, note the beneficial free-rider phenomenon that occurs in a free market. If the most sophisticated investors demand full information, the less sophisticated will benefit from the disclosure too. We see this throughout the market. When stores cater to the most conscientious buyers, they simultaneously help the least conscientious.

The call for regulation assumes — without grounds — that government can protect investors from con men. But government regulators have never been able to make good on this promise. Con men prosper no matter how much the government regulates. They often understand the system better than the people running it. (Madoff was an insider!)

Looking to government regulation for security merely adds another avenue for corruption. Ordinarily people are cautious when someone promoting a product stands to profit by its sale. But regulators are supposedly disinterested and don't profit by their activities. All they want to do is protect the public interest — and they have the state's imprimatur vouching for them. That's the theory at any rate.

In fact, they are human beings like us all, with the same kinds of motives, goals — and temptations. To the extent we think they are saints, we make ourselves vulnerable to scams. (Speaking of Ponzi schemes, check out Social Security and Medicare.)

What's the solution? Super-regulators to watch the regulators? And who watches the super-regulators? Face it: there is no security in regulation. Rather, there's only a dangerous illusion of security, not to mention a drag on economic growth as the bureaucracy interferes with honest traders.

The claim of free-market advocates is not that we need no protection from the unscrupulous. Rather, it's that protection is maximized by undiluted market discipline — profit and *loss* — and buyer-beware skepticism.

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