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Introduction

The study of fraud represents a tantalizing horizon for accounting research. Fraud costs businesses, investors and ordinary people incalculable sums, and therefore a motivation for its study is obvious on a practical level. More theoretically, fraud mitigation remains central in the justification for internal control implementation, auditing effort, and regulatory design.

Despite its immense potential, fraud research has not made major strides as a stand-alone academic area. The literature has remained heavily dependent upon anecdotal accounts. Most of these are autopsies that seek to do no more than describe in detail how specific frauds were perpetrated. Studied in this manner, fraud remains an exotic and episodic event, about which very little systematic evidence has accumulated. A great unrecognized need exists in evaluating contexts where fraud happens on a somewhat regular basis. In other words, although fraud may happen anywhere, we need to study those places where it is so regularized as to be arguably a way of life.

Fraud also has been theoretically impoverished. The majority of the conceptions offered depend upon the early conception of the fraud triangle. This formulation suggests that fraud thrives where: (1) opportunity to divert assets exists; (2) where the perpetrator possesses the unusual incentives to engage in a criminal act; and (3) where perpetrators are able to rationalize their behavior as less deviant than it appears to be. The confluence of these circumstances, being formed retrospectively, is believed to further the sufficiency of the theory. Although some have offered refinements or elaborations of the fraud triangle (see Dorminey et al., 2012), they work from a common songbook of requisite elements. This deductive approach needs to be challenged by an inductive research design wherein participants, who themselves are either perpetrators or witnesses, tell us what the fraud parameters might be.

The fraud triangle presents a fairly generic view of human action. People form intentions based on their *ex ante* circumstances. Their relationships to other people and their proximity to valuable property allow various behavioral possibilities to be pursued. Reasonably well-understood psychology necessitates some *ex post* reinterpretation that harmonizes their actions with their understanding of societal norms. Working within such a broad template should not be difficult as long as the Fraud Triangle is understood as a general framework, and not as theory *per se*. What has been missing is work that elaborates how actors understand these categories in general. In other words, in advance of a specific defalcation, what are the prospects that the golden triangle will result in a fraud? To discover such, we have to allow participants to tell us what opportunities present themselves, what motives are at play, and how people retrospectively live with their actions.

This paper explores the prospects for fraud (broadly defined) in organized securities and commodities markets. Surprisingly, this context represents a rather unusual one for fraud research. In many ways, these trading markets have evolved into a world unto themselves. As such they require inside knowledge

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in order to explicate how and why people commit fraud, and how they are able to go forward in the full knowledge of their transgressions. The vast amount of money that flows through securities markets on a daily basis makes them critical to appreciate. Moreover, as investors many of us are potential victims of abusive practices that are both difficult to understand and detect. In order to understand the detailed contours of participant behavior, we conducted interviews with thirty-one people with active knowledge of this environment, these included those that had been convicted of fraudulent acts and those that have not, all of whom proved quite open and frank with us. Their voices form the essence of this paper.

The balance of this paper is organized into six sections. Three of these embrace the areas of the fraud triangle by containing information pertaining to incentive opportunity and rationalization. This core of the paper is preceded by a brief literature review and a description of the data collecting effort. The paper concludes with a larger picture perspective on this work and the evolving literature.

Literature Review

Some effort has been exerted on defining fraud. This process is made somewhat difficult by the various contexts that the word pervades. For example, fraud is a reason to render contracts unenforceable and is a recognized intentional tort. The penal codes of every state attempt to define it for criminal purposes since fraud is deemed as a violation against the collective society, as well as its direct victims. Routinely fraud involves purposeful deception that results in the deprivation of property from its legal owner (Podgor, 1998; Weisburg and Waring, 2001; Clikeman, 2013). The term is broad enough to include a diverse set of schemes, artifices and devices to create false impressions, and includes intentionally violating a fiduciary duty for personal gain (Coenen, 2008). This diversity recommends that researchers spend time and effort in understanding the lived culture of the participants that sometimes become perpetrators.

Fraud as a recognized phenomenon has origins that go back to ancient time. However, its treatment in the management and related literature has been quite short. Those that recount this history usually credit Sutherland's (1939) designation of "white collar crime" with a pivotal moment. That crime could be committed by corporations and their agents, actors who usually benefitted from social approval, was relavatory. Taken to an extreme, this expansion in the concept of deviance introduces the prospect for corrupted cultures that nonetheless have high prestige and social permissions.

Cressy (1953), seeking to develop typologies of such violators, hypothesized three key commonalities. The first, pressure, created an unusual situation for an individual. Usually denoted in terms of extreme financial need, this factor served as the motivation whereby a usually honest person would be motivated to do fraudulent activities. Here, the classic example was an individual with gambling debts or with sudden and unexpected financial losses. More recently, pressure has been viewed as created by organizational action and entailed organizational rewards and punishment for individuals (Murphy and Dacin, 2011). Others have taken pressure into more purely interpersonal realms to include psychological inducements and peer pressure (Hutchinson et al., 2009). We believed that this element might be entirely absent, and that we could see fraud without personalized pressure. If fraud becomes regularized, it may take on game like attributes, such that it is done only because it can be done.

That the desire to defraud is insufficient leads to the second point of the triangle. To suggest that opportunity must exist argues that there must be a distinctive point of access for a person to gain dominion over the resources belonging to another. This could be mere physical proximity in the absence of physical restraints, or the privileges of a fiduciary in the absence of proper accountability. Opportunity also connotes a disproportionality between the perceived benefits of the fraud and the perceived costs of being detected and punished. When opportunity is high, the disproportionality in favor of the former is at its extreme setting. Here, how frequently and rigorously people scan and assess opportunity structures is placed at issue (Cressey, 1953). That people have access to both legitimate and illegitimate opportunity possibilities can be expected to shift the disposure toward action (Singleton and Singleton, 2010). Opportunity also needs to recognize that enforcement regimes, bringing variable certainty and severity,

are consequential to perceptions (Shover, 1998; Ramamoorti, 2008). In any particular context, opportunity should be highly nuanced and closely intertwined with the basic rationale for that which the organization is designed to accomplish for its clientele. Thus, opportunity is fed by the aspirations that are legitimized by the setting.

Rationalization competes the fraud cycle, allowing the individual to bring their action back into harmony with societal norms. Self-justifications for deviant action no doubt begins as the intention is formed and the opportunity is evaluated. However, rationalization is mostly associated with the mental realignment that becomes necessary after the fraudulent action is initiated. Rationalization is often articulated to others even later as perpetrators try to rally interpersonal support for his/her acts, reinterpreting them as rational responses to their situation, highlighting the pressure that existed. In the exceptional situations where fraud has become endemic, rationalizations should be more political than moral in tone.

A good deal of work has built upon the fraud triangle. Albrecht et al., (1984) for example builds a fraud scale based on markers for the three elements. Included here are observable factors such as living beyond ones means, a strong appetite for personal gain, a “wheeler-dealer” attitude, and beliefs that one is underpaid and insufficiently recognized. This work grounds fraud very closely into various dimensions of personal integrity and establishes the psychological nexus between temptation and personal excuse making. We suspect that the Albrecht et al., (1984) rings true in that it modernizes fraud’s motivation. The advent of a hyper era of consumption and wealth accumulation harmonizes with the less moral ways of the perpetrator that we expect to find in contexts where large rewards are routinely earned with esoteric effort and intangible action.

More work has been done that subdivides the areas of the triangle. For example, Kranacher et al., (2010) stipulates that a difference exists between honorable employees who are overtaken by circumstances or by bad luck (termed “the accidental fraudster”) from those that select places of employment on the basis of their fraud vulnerability (the “predator”). The fraud triangle should be recognized as a template upon which variation should be expected. Different ideal types should be expected in different contexts. This can only be discovered with a “boots on the ground” strategy for the conduct of fraud research.

Wolfe and Hermanson (2004) offer a fraud “diamond” by adding a competency dimension to their versions of the classic triangle. Undoubtedly, some level of skill would be needed in the planning, execution and disguise of the fraud. The frauds that will be most successful might be ones that illustrate higher levels of perpetrator skill. But since spectacularly transparent frauds are sometimes successful (at least for some time) and incompetent efforts are nonetheless fraudulent, competence would seem at best to be an aggravating factor more related to magnitude of harm. “Skill” is a highly context specific term, especially in area where innovation is prized and the “bottom line” is worshipped.

Kranacher et al., (2010) added what they call a MICE model to designate factors of money, ideology, coercion and ego/entitlement. This specification covers mostly familiar ground with coercion forming the pressure dimension, and ego/entitlement being another way to cover what is more conventionally entitled rationalization. In many ways, “money” is a means by which opportunity may be indicated. The unique part of MICE is the specification of an ideology of criminality. We readily embrace the notion that people can be socialized into fraud cultures wherein the peer pressure to achieve target result can be both enormous and virtually invisible to participants who have, as they say, drank the Kool-Aid.

In sum, the fraud literature exhibits the features of many other areas that only recently have become academic topics. Efforts to find a framework that allows researchers the opportunity to conduct robust empirical work should not be gainsaid as a worthy achievement. However, no matter how the framework is specified its elements lack much detail. However plausible, elements such as pressure, opportunity and rationalization remain vague ideas without a strong context. Perhaps more importantly, these notions need to be detailed by actors that reside at the wheel of the actions that are being contemplated. In other

words, how participants understand fraud is the only real way to put meat on the bones of fraud theory. Only in this way can we know if the theory is adequate.

The literature reviewed in this section could form the basis for any fraud study. However, as detailed in the next section, the securities market provides a unique opportunity to push the envelope of the fraud triangle. The most modern versions of the triangle offer wider zones of application with greater potential for fit to the securities market. However, one should never neglect the more generic task of trying to determine what the key words mean in the minds of participants.

Method

One reason that fraud escapes systematic before-the-fact investigation is that it can appear almost anywhere there are resources to divert. This runs the gamut from Fortune 500 environments (Grant and Marshall, 2002) to the sole proprietor professional (Lewis, 2000). This diffusion made confining study to a particular setting very important.

The task by which capital is allocated in the private sector is critical to a free enterprise economy. Those with savings can participate in returns made by business enterprises by purchasing securities and other instruments on the organized exchanges. These transactions require the services of many intermediaries, who are positioned by virtue of their employment or their ownership of a seat on the exchange, to effectuate purchases and sales. These parties also actively solicit buyers for a variety of offerings that vary in the risks and returns that are available.

The considerable information advantage enjoyed by professional traders creates potential for various types of fraud. To the extent that traders transact in a variety of hybrid securities whose risks and returns cannot directly be assessed but instead depends upon the fortunes of the underlying securities, large abuses are possible and detection is unlikely. Markets and exchanges are regulated, but such oversight is not generally believed to be effective.

Nobody except for securities traders are aware of how fraud in this environment can be accomplished and concealed. Therefore, semi-structured interviewing of those with current or past experience "on the floor" was used as the primary data gathering effort. Thus, the ambition was to probe the lived experience of participants who either have committed fraud or who have seen others do so. With the exception of vague organization of materials provided by the fraud triangle, the research utilizes a grounded theory approach (Glaser and Strauss, 2009) and allows patterns and regularities to emerge from these conversations (Ezzy, 2013).

People were selected on a convenience basis, leveraging the personal connections of one of the authors. This process yielded a sample of people most of whom had no fraud record. In order to ensure that more fraud instances would be represented, solicitations were made to a random sample of those charged with violation by the Financial Industry Regulatory Agency (FINRA). Interviews were recorded and subsequently transcribed. Guarantees of confidentiality were extended to all interviewees.

The final sample consisted of thirty-one people, and included twelve that are known fraudsters (based on their presence on the FINRA database). Paralleling findings in the literature, the sample was predominantly 91% male. The average age of the group was 49.3. Average work experience was an impressive 24.0 years. Table 1 provides more information about the sample.

Table 1: Respondent/Interviewee Profile

Attribute	Description
Gender	29 males (91%), 2 females (9%)
Age	Average: 49.3, Youngest: 30s (3), Oldest: 60s (9)
Education	Undergraduate (19), Graduate (12)
Experience	Average: 24 years, Low: 3 High: 40
Fraud	Known records: 12, No records: 19

Findings

Following the wisdom of the literature, the commentary offered by the interviewees was organized as it related to incentives, opportunities and rationalizations. Although other means existed to sort the commentary, this outline is offered as that which would be easiest to recognize.

Incentives

To the extent that fraud is an antisocial act that exposes the perpetrator to collective disapproval and official sanction, strong actor motivation is believed necessary. Often, the presence of extraordinary circumstances is needed in order to make sense of the deviant behavior. In the classic fraud triangle, incentive morphs into "pressure," suggesting contingencies that usually are not present for decision-makers. That the fruits of fraud are invariably ill-gotten financial resources, suggests that some financial need is present. How sympathetic we might be in this situation might be a function of how blameworthy the focal person might have been in the development of their crisis situation. In situations of moral turpitude (e.g., gambling debts), the individual is somewhat foreclosed from receiving help from others, since the problem is rarely admitted (Albrecht et al., 2011). More recently, the recognition that fraud is not necessarily an individual act, but instead an organizational conspiracy, suggests that perpetrators may be motivated by the wish to retain their organizational position (Shafer, 2002).

1. It's All About the Benjamins

The interviewees were fairly supportive of the idea that money is the primary reason that motivates traders. In fact, several respondents treated the primacy of financial rewards as the reason that anything is done as "obvious" or "strictly." That monetary motives stand alone in this fashion reflects the strong culture that traders are paid on performance. This allowed several respondents the opportunity to reveal why one security is promoted over another. Money is wanted not because of some exceptional need, but instead just because it is available. What is more difficult for interviewees was to get them to recognize that non-financial motives can co-exist ("personal pride" according to one). Chronologically, the dominance of money as a motivator for everyone did not prevent some to be amazed at the avarice of others. As put by one, "what people do for money, it's unbelievable." Another told a tale about a hedge fund creator that included "his whole idea was he wanted to be one of these people that was worth at least a billion. And that was his goal." Regarding their own motives, traders tended to be matter-of-fact, and certainly unapologetic. One cited declining rates on commissions as a reason for the hunger: "the pay for trading has gone down." Another tried to put compensation in relative perspective: "I'm creating all of this wealth for the firm and it's fantastic, but I'm not being paid commensurate with what I'm doing."

2. Greed Comes with the Job

For the large part, the financial incentive that motivates traders is a routine characteristic of the business. As one person noted:

> "People are down here just trying to make a living. We're trying to hit singles every day and several times a day, and we're not trying to hit home runs."

Transactions that look to be the product of a fraudulent advantage are outliers that need to be put in a wider perspective.

> "Well, he bought ten call options on XYZ and it got taken over. We said well, do you want to see the other 20 companies he bought calls on that he lost money on?"

A slippery slope exists wherein small bets and subtle positions develop their own logic and justifications, becoming ethical violations not by plan but by their own inertia. For example, "He instead continued to build the position 'cause he saw it as being better and better and better; thought he'd be the hero, and ended up losing his job and the firm quite a bit of money." One person attributes these tendencies to a failure to take the long run view, and therefore, created an unsustainable disposition.

> "There's no economic advantage in the short-term in doing that. A lot of the firms seem to have a short-term nature. They hire someone. They pay them bonuses, and then that person is gone in just a matter of two to five years."

Trading firms are under considerable pressure, making the truly honorable path a difficult choice. This pressure was described by one person as follows:

> "You're running this big office. You've got this big nut,[1] this fixed nut and everything that you've (doing)."

No surprise needs exist when this pressure trickles down to individuals.

> "You create a new product and you're trying to force people into that position[2] and you're highly incentivizing the people you're paying to do that, that seems like something that again, not illegal, but certainly not right."

3. Play to Win

Trading is an occupation with strong gaming elements. Interviewees acknowledged such a motif in a variety of ways. People tended to be self-acknowledged competitors that took losses rather personally. One succinctly expressed a strong desire to win as follows: "I can shine. I can win. I can beat everyone." This may have made the financial rewards less important:

> "I've always approached this business as a game where you have a lotta smart people playing pretty on pretty much the same playing field. And you're trying to basically—the money you make is almost like a scorecard on how you've done relative to the other smart people in the business."

Played in this manner, others are judged by their shrewdness and expected to try to get their own way. At the same time, gamesmanship required some expectations of subsequent reciprocity:

> "If I ended up having to take a loss for them, then I don't want anything other than fair treatment in return."

Such an environment breeds various actions. Predictably, more freedom to play was desired.

> "We were testing the limits of how much or how far we could take grey before it became black.[3] And that the game we played every month."

Less anticipatable is the game that is played for its own sake.

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[1] "Nut" refers to the variable and fixed costs associated with the office.
[2] "That position" refers to the practice of pushing an internally created securities product onto clients, ostensibly for increased commissions and profits for the firm.
[3] "Grey before black" refers to the practice of performing a questionable act, increasingly pressing the boundaries of the intention of the law (grey) before prosecution (black) is likely.

> "Some of them would do it because they were bored and they wanted to make good use of their skills."

Sometimes this behavior had quite dysfunctional consequences.

> "All of a sudden you hear all these derivatives…and it was an absolute disaster and it just literally blew up. Then you get down to all these derivative things and nobody understands the risks involved and the person that's actually guaranteeing the derivative is indeed the financial security of that organization."

Incentives also need to weight the prospects of detection and sanction. *Ceteris paribus*, effective regulation would offset strong motivation to commit fraud.

4. Damn the Torpedoes

Interviewees generally had little regard for the reputation of their markets. Various reasons for such were given including systemic conflicts of interest and poorly designed incentive alignments. More than one found regulation to be backwards-oriented. They are seen as:

> "Somewhat ineffective because they are addressing or protecting us against an event that is unlikely to reoccur."

Such a situation contributes to non-substantive compliance exercises that fail to become a material factor in offsetting incentives to commit fraud.

> "I probably had over fifteen friends in the industry, some at my own firm, some at others, and everybody was doing some variation of this window dressing."[4]

For some, the civil fines are a cost of doing business, easier to pay than they are to comply with. For others, outwitting the regulators adds another layer to their game. There are more serious violations that may cause people to lose their jobs and to have difficulty finding other positions. However, for most part, these are remote, if not hypothetical:

> "If you look for a job in the future, everybody ask for your U4,[5] and if there's a compliance violation on it, you won't get the job."

5. Summary

In sum, traders do not seem to have the same mental states as suggested in the literature that would lead them to fraud behaviors. They do not seem to be the desperate down-on-their-luck folks that commit acts out of the lack of any other option. Instead, they seem to be people interested in elevating their income mostly because they can. That this must be done over the opposition of others presents strong gaming challenges and large ego boosts.

Opportunity

1. The Basic Gambit

At the most general level, opportunity to commit fraud is understood by traders to be less rare than most readers would suspect. The prospects of fraud occurring was nothing exceptional but, as one person suggested "there will always be excesses." Another person was more aggressive, suggesting philosophically "there has to be an element of interpretation." People differed with regards to the

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[4] "Window dressing" refers to the practice of portfolio managers improving the appearance of their portfolio near the end of the quarter or year by selling securities with large losses and buying securities which had strong returns for the previous period. In this manner, when the positions held are reported after the end of the period, the portfolio will seem to have been well managed (on the surface).

[5] A Form U4 is required for representatives of broker-dealers, advisors, and issuers to register in the appropriate jurisdiction with the appropriate regulatory agency. Disclosure of previous criminality is required on this form.

importance of costs in an environment so rich with the possibilities of fraud. This ranges from one of an increasingly sophisticated "credible threat" to one of informed self-control, of this quote: "you need to be able to walk away from business if it doesn't feel right."

Securities do not just trade themselves. Exchanges have required that some traders play the role of "market maker," a function suggesting the delegation of responsibility for matching bids and asks. This individual is in a unique capacity that is more disposed toward conflicts of interest. One interviewee offered this example:

> "Market makers are allowed to sell short when they are participating in legitimate market-making activities, which means that they're posting a bid and an offer, and buying and selling all day long; if a market-maker is taking advantage of the ability to sell short without having to locate shares because they wanna benefit from the stock moving lower, that's definitely a violation of the trading laws."

Traders tend to "follow the money" and therefore are more likely to participate in activities that have more generous commissions. Whereas nobody would question such behavior in ordinarily structured transaction, commissions are sometimes layered so as to purposefully feather the nest of traders. This behavior ultimately was paid for by unknowing investors through higher than necessary transaction costs.

> "Really, what was happening is you'd have people that were friends of friends, and they'd sign up as though they were helping run the offering, and they'd get paid a couple percent of the deal as long as they participated. You had traders that were actually getting paid percentages of deals when they were finding anyone. They were just getting extra edge[6] to trade in the product that we had created. What would happen is people would feed their friends, and their friends would then take care of them in return."

In a rising market, such abuses mostly pass unnoticed:

> "Who's gonna complain if you take four percent of their money if they're handing you back forty percent, fifty percent return?"

With so many trades requiring the cooperation of traders in different organizations, squabbles are likely and some traders have the power to cheat others, as per this account:

> "The Treasurer at their brokerage firm made sure that TradeCompany (pseudonym) got paid first on a bunch of things, and they gave a lot of other people the short end of the stick. And what ended up happening was he ended up getting a job there making a lot of money as a result of doing that sort of thing."

2. Working for Number One

Traders are allowed to work on behalf of their clients but also work for themselves. One major type of fraudulent activity is to pursue the latter to the detriment of the former. Often this involves the strategic ordering of transactions with those that come first having an advantage not enjoyed by later ones. Since securities are very sensitive to supply and demand, each transaction tends to change the equilibrium price, and therefore there is an advantage in "front running" customer orders. This quote describes the general opportunity seen by the traders:

> "They see a large block order come forward and they just got a computer that…can go outside of that and execute a trade. Trades are highly complicated, Mr. B, and I'm not an expert in this by any way, shape or form. But it's trading away from the general exchanges

[6] "Extra edge" refers to the commissions these traders collected by misrepresenting their efforts in locating new customers to purchase a new security in addition to their own trading profits, often in conjunction with an initial offering of a derivative.

> in a lot of these others areas, but they can see large blocks of trades and overhangs and then just get out in front of that."[7]

To curb the worst forms of abuse, regulations exist. However, traders invent their own structures to free them from these strictures. For example:

> "It was like a constant trying to dodge that—try to net short the stock, and it was always stocks that were on the reg show list. And we also had somebody that was like an outside investor with TradeLink (pseudonym) that was directing what stocks to trade. So it basically was his own little personal brokerage firm that allowed him to get around the rules. They have since done other things with that desk, but at the time, that was the motivation behind setting up the desk."

The lesson for traders seems to be that if one's position is not conducive to what one wants to do, invent a new position.

3. The Number of Ways to Skin a Cat

Markets tend to be very fragile places, capable of upset when collateral purposes are brought to bear upon them. Naïve observers of the markets tend to believe that traders are driven by the issue's fundamentals to buy low (under-valued) and sell high (over-valued). That the game is actually much more complicated, and tends to be more about form than substance, comes as a surprise. Some transactions are pre-arranged. Others are pure "dividend plays." Other are efforts to "paint the volume." Traders use their positions not only to know more than others but also to let others know they have information edges, and to then send false signals to which others would react. As one put it:

> "I could easily sway the markets by putting in bids on the screen and calling everyone to go to the floor directly. So there were a lot of things where you could influence how you are actually trading a stock."

Sometimes, an even larger set of contingencies was involved:

> "Often the whole reason they're doing it is they don't actually even care if they make money. They just need to scratch[8] on the trades. And what I mean by that is if you can do enough order flow on some of these exchanges, and so the exchanges themselves are contributing to this problem, you get a rebate and that rebate adds up to enough money to pay your whole operation."

4. Some Firms are More Equal than Others

Traders do not tend to be independent contractors or entrepreneurs. They work for firms, and as a result how firms are organized creates differentiated position and variable potential for interaction. One trader described his firm as organized:

> "On a very ad hoc basis, which meant that the different business lines operated as silos, and there was no centralized control."

This choice creates the potential for abuse, especially when combined with heavily incentivized compensation. This situation described below is very common, reaching the media only when numbers get extremely large.

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[7] The process refers to the controversial practice in which some high frequency traders are suggested to have entered orders in advance of known orders originating outside an exchange due to their physical proximity to the primary computer networks which handle orders for an exchange (Patterson, 2012).
[8] "Scratch" refers to breaking even.

> "So we had a trader who kind of went rogue on us. We told him he couldn't do a trade above a certain size. We didn't want him to do the trade. And he kind of quietly did it unbeknownst to us. This is nothing illegal. Probably, it is 'cause I think we had a contract; maybe verbal, maybe written—but at any rate, lost a bunch of money for us doing something sneaky, and we ended up firing him."

Another version of this conflict of interest involves the discretion given to traders to create inventory for clients or to reserve an issue for personal ownership. This dilemma is confronted in the following quote:

> "You're cutting out the street,[9] as we call it, how do you know someone in the street wasn't gonna pay you more for that bond? And you've ripped off your fund holders."

5. Shooting the Gap

Trading securities often involves the exploration of arbitrage opportunities. Prices may vary in different segments of a market, and clients can benefit from a trader's intimate knowledge of these differences. Unfortunately, this may work to the disadvantage of those with limited range (i.e., small traders) as the following illustrates.

> "The big firms go ahead and trade it for themselves. They go traded on another exchange where there is a rebate. Basically, they traded away from you."

The fraudulent opportunities that traders possess may relate to their employment by entities with incompatible operations. The ability of the firm to refrain from exploiting the information created by one for use in another may prove irreversible.

> "Despite the fact that all these guys claim they have Chinese firewalls and no one is able to talk to anyone, common wisdom suggests that they all communicate cross platforms that they're efficient."

6. Knowledge is Power. Power is Position

Traders not only make trades but are also the main repositories of information about these transactions. This dual functionality opens some unusual prospects for fraud, even if it is not meant to achieve personal gain:

> "I know two people that went to prison for violations and one of them was changing prices of a trade after it closed. And I saw this firsthand, but he did it to help the broker."

Albeit not fraudulent, the position held by traders put them into the awareness of the motivations of sellers and the constraints that others are under. This information is often used for personal gain, rather than for client advantage.

"It was expiration morning, and he was selling the calls that were expiring that day. Back in the day you could buy the calls under parity, exercise the stock right away, and you could lock up maybe an eighth or a quarter. This guy—it wasn't an illiquid stock but it wasn't the fastest moving stock in the world. Only one other trader in the pit traded it. He and this guy bought the sell for a dollar under parity."

The market participant occupies a position unlike any other. That which the trader is asked to do is rife with conflict of interest potential that are difficult, if not impossible, to avoid/resist. In other words, opportunity to commit fraudulent acts does not require a devious imagination. It only requires people to be positioned where they have to be in order to do their work.

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[9] "Cutting out the street" refers to the practice of internally matching buy and sell orders and collecting commissions off of both orders without introducing either order to the normal price discovery that occurs in the marketplace.

One of the dimensions of the positions held by traders is their simultaneous management of multiple accounts. Regulations pertaining to appropriate account balances can be bypassed. As put by one:

> "Let's say they get hit in 2008 with a squeeze meaning there's not enough money somewhere. They can shift the money around between all of the accounts and everybody balances out and there are no regulations that are bothered by this."

7. When in Doubt, Make it New

Unlike most people, traders can create their world and therefore actively design their opportunities to exploit others. Others with aspirations toward fraud have to accept what a pre-established environment offers. As part of this, a juxtaposition of industrial espionage and stolen intellectual property appeared:

> "They started a fund of funds with the intent of going in, seeing how other hedge funds ran things, and stealing their people, and stealing their ideas."

Here, the legitimacy cover is due diligence, a necessary practice. More important is the opportunity that street participants have to design new instruments with unusual features. The outcome of this creativity is to advantage insiders, albeit for very short intervals.

> "I know what I own. You know what you own. Wink, wink, nudge, nudge. I'm going to sell mine off. I'm going to buy back. We are going to find a way to make it up to each other over time. In terms of what the actual wins or losses were, if not, have a little contract to do things, and will call this contract the derivative. The derivative will derive its value from the price of XYZ stock on a certain date. Really, what we done? We've created a way to get around rules."

Position plus innovation ability usually translates into a material asymmetry of information believed to be critical.

> "The only way that you could succeed was basically getting an inside information advantage on other people."

This information edge worked in many discrete ways. Sometimes, all it required was simple distortions of the truth in ways that would benefit themselves.

> "The guys that wanted to make—write a ticket,[10] even though they knew it was a crappy company, a lot of guys would talk their accounts into doing it if they thought that the deal would work for even a little while. Then, a month later, they could talk them out of it and get them out of the company before it was too late."

At times, more than commissions are at stake.

> "Top XYZ executives knew the market for the securities was collapsing. Seven of XYZ's top executives were said to have dumped their own holdings totaling twenty-one million dollars even as they told the bank's brokers to mobilize the troops and unload the securities on unsuspecting clients."

A variety of techniques are useful in the process of exploiting superior information, including reversals that allow trades without real risk, and the bypassing of the usual intermediaries. Such activity requires knowledge of ways to avoid reporting what really took place, "All of the stuff was off balance sheet, too. I don't think anybody in ABC ever even saw it. When the Board got the financial results, they would never see this." to "The boss buried the loss. Told the client they didn't execute it quite quick enough. The client probably took a bigger hit than they should have." Much of that which is clandestine is not the

[10] "Write a ticket" refers to the practice of entering into a trade.

structure of the transaction, which following regulations are properly recorded, but the motives behind it which often involved insider information. One interviewee summed this aspect up as:

> "There's a lot of stuff that going on behind the curtain."

Along with the existence of differential information, fraud requires relationships beyond the existence of a rather naïve and suggestible customer base. There are friends and enemies to be engaged in the process of getting what one wants. Sometimes the former involved "sell-side people to go and get information for you," or other firms that will "kick back business to people that gain them good ratings and reviews" or a boss who when "asking you to do something, you know he would it himself." Some deals required qualitatively different connections.

> "You've got to have relationships with the big firms to get these things done. In the bigger communities and some of the larger institutional investors, they all know the game. It's a wink and a nudge."[11]

Wherever these contacts existed, it was necessary to "feed your friends." This provided some downside protection. After bridges were burned:

> "Low ethical people in Wall Street probably had a lot of mobility to go from one firm to the next for a number of years."

Meanwhile, those empowered to police the markets were kept at bay with incompatible reporting lines or by the indecipherability of what actually took place in deals. With compliance, one person said:

> "We were testing the limits of how much or how far we could take grey before it became black. And that the game we played every month."

8. Coming and Going

The opportunities open to traders to commit fraud in large and small ways appear both omnipresent and esoteric to those uninitiated in the business. The commitments made by some players translate into opportunities to be exploited by others who recognize vulnerability and the lack of options. Sometimes, advantage is extracted through unexpectedly revealed arbitrage plays ("shorted here, convert and capture the difference"), excessive commission taking ("when you add it all up, you could lose three to four percent of your initial investment") or discretionary allocation ("you can pump performance in one or bury something in another"). Sometimes, traders used code words to guarantee the evidence they needed ("I'd be asked to clean up the reports and I knew that was code for making it a stronger analysis"). For customers, ample opportunities existed to "put lipstick on a pig and sell it." Between traders, fraud often required creating various illusions that the interviewees routinely called "wink, wink" or going through the motions, as in:

> "He would be waving his hands as if he was trading with you, but he really wasn't trading, he wouldn't check trades, he'd deny to trade with you…just to push the market down."

Traders, as a last resort, could just deny what took place.

> "If someone made a trade that they knew went south,[12] the famous thing is you hide the ticket, like you put the ticket in a desk or wherever."

9. Summary

In sum, the very nature of securities trading presents itself with enormous opportunities for fraudulent behavior. The complexities of the deals that are constructed make it very difficult for such opportunities

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[11] "Wink and nudge" refers to implementing unethical practices without needing to create a paper trail based on the familiarity between the participants.
[12] "Went south" refers to a trade which lost money.

to be suppressed. The fiduciary nature of the traders' undertaking is rife with potential for abuse, most of which is so subtle as to escape detection. The spirit and the letter of the traders' work are all too readily parsed.

Rationalization

The third and final element of fraud in classic conceptions is rationalization. Taken from early psycho-analytic studies (e.g., Jones, 1908), rationalization entails the process whereby people come to understand their own behavior. Rather than see such as would a neutral observer, the actor employs perspectives that put themselves in a more favorable light. Situations are often redefined blame is cast elsewhere, in order that the actor's self-conception as a moral individual can be preserved (Cherepanov, Feddersen, and Sandroni, 2013). While rationalization has many applications, it is particularly relevant to fraud due to the social condemnation that typically is attached to that action. People who commit fraud often have abused their fiduciary responsibility to others, and thus would seem to call for revised self-conceptions. However, rationalization, as verbalized for both external and internal consumption, attempts to restore the idea of a person worthy of trust (see also, Albrecht et al., 2011). Rationalizations should not be conceived of as mere after-the-fact distortions of reality, but in many ways may be before-the-fact facilitators that make fraudulent behavior possible.

1. What's in a Name?

Rationalization can be understood as a stylized general interpretation of ethical behavior. Interviewees tended to be interpose a considerably-sized gray area between right and wrong. This statement suggests two such lines:

> "I think there is an official version of fraud, what is permissible by law and some sort of the rules and regulations that you have to adhere to."

Another exhibited surprise, as he remembered not finding the middle zone at one firm:

> "But it was one of the most squeaky clean firms I've ever worked for. If there was a grey area, you weren't even allowed to dip your toe over it."

Traders are expected to constantly attempt to redefine their permissions. One interviewee put this bluntly:

> "And so they were constantly testing the limits, and I would expect them to. This is their job. And that's the reason why you need to have a strong compliance team to look under their fingers and make sure they're not going too wild."

This effort was sometimes looked at in terms of the money involved, with smaller amounts easier to dismiss:

> "It was a time when we were extremely busy. It wasn't a large amount of money. It wasn't enough to trigger any outpoints. It was relatively small."

Other times, redefinition was done linguistically. When asked about a particular offense, one person quibbled thusly:

> "I wouldn't say violate, okay? That's a strong word."

2. Everybody's Doing It

Yet others resorted to a version of the *ad populum* fallacy to regret the cost of right behavior:

> "We would hear that they would go to somebody else that would accept the business. I'm sure the ________ guy I just described, he found somebody in Switzerland that was willing to take the money."

People felt better about their indiscretions if they could identify the line that they would not and did not cross. This tends to be a subjective internalized matter that traders accept. For one, some degree of righteousness remained.

> "Now, am I a saint? Am I doing this to try to help people? No. I would totally be lying about that. But I'm not going to go into areas where it's people's retirement funds."

Traders who maintained self-images as people who did a good job and did what had to be done. Versions of a Nuremberg defense, combined with the suggestion of an alternative normative order, were made when things went wrong.

> "This isn't my decision to make. This is someone's higher up, and I'm just following orders. And so, I did it. It's not something I'm either proud or all that unhappy about. I mean, everyone does it. I wasn't the only person doing it."

That illegal behavior ran rampant was often illustrated by stories of elaborate gift giving to people able to throw business in particular directions:

> "This was the early 2000s. It wasn't necessarily that we had any concerns of bribery or whatever you may call it, or non-cash gifts that were given, all these things. But I would say that we were within some sort of the average behavior of asset managers at the time."

3. The Government is at Fault

There was no shortage of criticism for the way that the rules governing trading behavior were enforced. This ranged from their over breadth ("People do it all the time but it's actually illegal") to their maliciousness ("It's fairly upsetting to think that a regulator can come in and shut you down when all I did was try to follow the rules") to their draconian consequences ("I paid a heavy price") to their un-knowability ("I still don't quite understand the reasons").

4. All Truth is Relative

The best breeding ground for rationalization is where there is no firm allegiance by social actors to an independent truth. The interviewees reveal a strange relationship to any version of the truth. The high degree of complexity, best attested to the ability of employees to design instruments that even their supervisors do not understand, allows intention to be devised to fit motives. Put by one:

> "They asked me what was going on and I told him that I had this extra fund on the side. That this extra fund was helping firm operations and I basically lied about what the purpose of it was. To my surprise, my boss looked at it and bought the story, and moved on."

Lines between right and wrong are rarely clear:

> "So again, it's not something that they did illegal. It was just the interpretation was somewhat more relaxed."

Since a great deal of tolerance exists for "spin," more bald-faced lies are also tolerated in the traders' culture. This takes various forms from compliance-motivated adjustments ("You know exactly when compliance is going to look at your portfolio") to the false claim of insufficient knowledge ("It's not like I was deceiving them. I just waited for their call and the claimed ignorance") to inadequate memory ("All of a sudden, the guy doesn't remember the trade the next morning"). In describing a firm training program, one interviewee reports how "it was almost like how to bluff other people." In a world of mendacity, what is the truth lives a precarious life.

5. I am not as Bad as I Seem

Perhaps the best way to see rationalizations in a way that goes beyond self-serving verbalization is to examine the cover-up attempts that are freely admitted. One describes his sacrifice:

> "I put my own personal money in here to cover this, I put this in, and at the end of the day I had violated rules."

Others report their clever efforts to reverse transactions after inspections and to blend funds that involved different representational capacities. With some degree of pride, another discusses the importance of size:

> "It's private. I don't open up the books. It's small enough and I keep it small enough to stay off the radar, but I've got enough contacts to make it work."

Deviation from the rules of the floor also has to be put into the context of performance. Enough good results are thought able to wash away more than a few sins. In general, the pressure for good results is offered as an excuse for the cutting of corners. One graphic renderings of would they would have us understand:

> "You are only as good as your last trade, so an hour later you're shit on someone's shoe again."

Traders offered little resistance to the propriety of what amounted to two sets of rules, one of which advantaged the superstar performers.

> "Well, do what you can to figure it out, but we don't wanna bother him. He's our whale. He's our big player."

6. I Answer to a Higher Authority

Rationalization requires a reinvention of the law. Part of this involves the insistence that other aspects of the situation be given significance. A large part of this is the insistence that a higher ethics of fair play needs to be followed. As explained by one:

> "So it's knocked down to an even cap, which I know the courts don't care about, but then it's down to make things correct."

Traders want some degree of credit for trying to follow the rules, or at least for being motivated by making money in socially approved ways. Here, they are quick to point out the dysfunctional consequences of regulation ranging from the necessity of holding bad stocks to selling good ones to balance portfolios. Traders believe regulation is too restrictive, since the market itself usually punishes the excessive risk takers.

> "So I'm arguing for less regulation and more common sense. And make people responsible for their actions. So what I'm saying is you should have a symmetric risk return incentive structure. If you do well, you should get paid all the money that you deserve. However, if you screw up, you should get punished for it."

Another person wanted to make the line between a violation and good practice less clear, perhaps creating space for informal settlements of disputes.

> "It only seemed reasonable. Everyone backed down and did the gentlemanly thing, which is part of the old school nature of the business."

7. They Are Picking on Me

In addition to believing that regulation was the victory of form over substance ("They went down their check boxes") and manned by people that did not understand trading ("Again, a lot of rules made by people who have never been in the business"), interviewees found legal constraints to be unequally applied and focused excessively on exceptional situations. To wit:

> "If you have regulation that focuses on the outliers, there's a problem. Regulation should focus on the average."

Ironically, the interviewees also portrayed regulations as ineffectual. Although bothersome, its failure to accomplish its intended purpose goals proved it to be not worthwhile. Regarding recent notorious fraud cases, one person said "…no matter what you do, they are not going to catch you." Another suggested that this was a systemic bias.

> "If there's any doubt in their mind that it might be legit, they're incentivized much more highly to just look the other way and say, "I didn't catch that," until it becomes big enough to be an issue."

Finding fraud is in nobody's best interests if:

> "The government is trying to manipulate markets to make these things hold up or move higher."

8. I Stick Up for the People that Matter

Rationalization also thrives within the power of relationships to trump reason. Interviewees held out the power of their interpersonal connections to their peers to guide behavior. Although the stories were not always about helping friends, there was a strong sense of a collective fate over the longer term within tales of retaliation against those that did not cooperate and favoritism toward those that did.

> "The next time he had a sell order, he always heard you first if you were one of those guys taking care him."

Transactions were large enough so that such a bias made quite a difference. One sought to engage in:

> "Taking care of the broker so that they would stay in business, and we could make money with the real paper flow that was going."

Therefore, rule bending behavior was not just self-interest, but also are made to fit within the category of system maintenance.

Notwithstanding their indiscretions, traders pride themselves in taking care of their customers. If possible, customers should to be immunized from loss, and to take what they are entitled to out of transactions. Traders tend to have more support for regulations that have the immediate impact of making the market safer for retail investors. An extreme articulation restricts fraud to where customers are hurt.

> "But fraud is always, to me, that you are either enriching yourself in an inappropriate manner, or you're depriving somebody else of those benefits."

On a more abstract level, traders take credit for constructing what could be called an efficient securities market:

> "And so our job was to make good, fair, tight, accurate markets, and that's what we did with arbitrage. So again, with these deals, that's what we were doing. Sure, we were trying to make money, but we were also trying not to rape and pillage[13] the public."

9. I am the Little Guy Here

This effect creates benefits for all investors, but also allows traders the benefits from discovered inefficiencies. Here, traders believe that they provide the critical human element that technology is beginning to squeeze out of markets. The human element made unnecessarily sharp fates more difficult, and allowed for the easy rectification of error.

> "Because the human base was taken out of that trade you're screwed. It's not a gentleman's business anymore because you know being in the pit if the market or something was one and a quarter, one and a half thousand option, and you paid three and a

[13] "Rape and pillage" refers to stealing excessively from the public.

> quarter for it, well, everybody and their brother knows that you made a complete mistake for that strike price you were thinking about something else or ________ and the trade was busted."

10. Summary

In sum, rationalization among securities traders is an elaborate values position, involving many well-defended positions. These combine a belief that traders do well on average for the investing public with the idea that they are persecuted by needless regulation.

Discussion

This paper used the interviews of equity traders on U.S. markets to find deep nuances within their understanding of fraud and related forms of deviant behavior. In general, the results assert that this context is unlike any other. In other words, fraud cannot be understood except as it refracts that which these market allows, rewards, and exist to further. Fraud also needs to be understood within the specific values configurations that thrive in such environments.

Fraud research has offered the existence of three elements that tend to co-determine fraudulent behavior. Accordingly, this paper has used opportunity, incentive, and rationalization as a way to organize the life world of traders. The top level take away is that traders have systemic opportunity to defraud, require very little special incentives to do so, and have no shortages of ways to justify behavior that is not sanctioned.

This paper does not take a position on the adequacy of the fraud triangle, or its structural integrity. The fraud triangle is serviceable to categorize elements of the conversations with traders since it is neither one-dimensional or excessively granulated. However, other insights may have resulted from a different typology. If anything, the present research calls for a more multi-dimension articulation of fraud.

Going back to the initial governmental involvement in the securities markets, the need to ensure a "level playing field" has acted as a guiding metaphor in this arena. For this paper's purposes, market fairness also serves as a meta-context for the phenomenon studied in this research. In a nutshell, changes in the markets may have altered the way participants conceptualize fraud and other forms of deviance.

Today's markets are dominated by big traders that wield the collective power of institutional monies. Size disproportionately concentrates power and favoritism. As put by one:

> "It was just known that you were either their buddy, or you never got a good trade, or you never even saw the good trades."

The new market makes traders somewhat nostalgic for previous arrangements.

> "I would still, in my core, hope that the marketplace would work fairly, that the little guy could be protected, that the big firms didn't wield the power they do and so we have a fair place. At the end of the day, if we had a market like that, I'd be a happy participant in it. I'm just a realist and I realize that we don't."

Traders fear lost investor confidence, seeing signs of it everywhere but especially as a reaction to large-scale misappropriations.

> "Every time something like this happens, it takes participants out of the marketplace, and I think it's bad for everybody that works in this industry."

Those that work in smaller operations find themselves increasingly disadvantaged when others are both "too big to fail" and "too big to prosecute."

> "But in some senses, they have a sniff there of what really is going on. So yes, I think that the biggest problems in the marketplace are information disadvantages that exist based on your status in the marketplace."

Whether the increased difficulty to imagine a level playing field translates into more fraud would be a speculative assertion. *Ceteris paribus,* this new order reduces opportunity while increasing incentive and rationalization.

Any paper that centers a problem should offer to its readers ways in which the evil can be, if not solved, at least ameliorated. Traders are the font of many ideas on the subject. Ironically, regulation produces not just an excuse when it is defective, but solutions if it can be made right. Unfortunately, irreconcilable directions for governmental control are offered.

Those that favor stronger regulation efforts start with the wish for regulatory personnel that are more knowledgeable:

> "Until they start hiring some of the smart people that have actually done these jobs, it's not going to go anywhere."

The advocacy of random (as opposed to scheduled) inspections, combined with the need to form teams of regulating personnel with different deep expertise, would render enforcement much more expensive, a factor not contemplated by its proponents.

The goal of regulation should be more transparency at the transactional level, but interviewees do not seem to agree what this would entail, and it tends to weight against the advice of letting go of the minutia. At the micro level, regulation might be like the paradox of the good tax, insofar as everyone believes that they should hamper others only. At a grander scale, support existed for various ways to reinstate the Glass-Steagall Act. The incompatibility of investment banking and commercial banking found several different expressions. That conflicts of interest were endemic also underline related suggestions to breaking up big players merely because they are too big to fail or because "Chinese Walls" do not work. One person put this suggestion rather bluntly:

> "Investment banks shouldn't be tied to brokerages. Brokerages shouldn't be tied to the research division. The products division probably shouldn't be tied to the brokerage division, either, because otherwise, you always end up having firms that are incentivized to sell their own products, to go out to the market and do things that benefit all the department. Personally, I would split these up. I think it's a bunch of crap that they're all together."

Equally vociferous were those who said less regulation is the answer. The return to a self-regulatory platform was equally accompanied by the call for higher ethics among market participants, and the belief that reputational protection was a sufficiently strong incentive. Interviewees recounted instances of participants that were shunned. The need for more traders to recognize the importance of trust was embraced both positively ("You don't really want to hurt the other members of your family") and negatively ("The market will punish [unethical behavior] in real time, not two years later"). Proponents believed that less formal systems aligned incentives ("This is what I call a symmetric incentive structure") without assuming that "all the apples are rotten" as current regulation tends to do.

The contemplation of fraud in securities markets also invites consideration of the magnitude of greed that is necessary or desirable for the proper functioning of the capital market. Some types of fraud exist only slightly over the line from what most would consider the healthy pursuit of self-interest. How much leeway should exist for agents and other intermediaries in the pursuit of client advantage is a question that has to be answered before progress can be made on the proper processing of trader fraud. A serious assessment of who benefits would seem to precede more tactical questions that would decide how visible

transactions should be, and how much form should precede substance. In the end, we need to decide what ends should be pursued. One more thoughtful trader summed the big picture up as follows:

> There's more and more focus on the professional community on how we create money for ourselves in the next few seconds, and less and less focus about how we create money for our clients. What that does is it creates lots and lots of gains in the short run, but I'm not convinced in the long run it's a good process for our marketplace, our country or, actually, the world.

What, then can regulators do, given such a strong fraud environment? Payment for order flows, the practice where exchanges compete against each other to pay for orders to be routed to their own exchange, needs to be eliminated. By allowing this practice, regulators turn a blind eye to the fair and just principles established in the Exchange Act of 1934, introducing the potential for public to lose faith in the marketplace. Additionally, regulators should consider utilizing ex-traders to supplement investigations. Several of our participants noted a desire to help regulators during their retirement years. By using this group, the knowledge base of current regulators can be expanded and frauds unlikely to be uncovered in the current group of examiners might be found. Additionally, large firms have too much influence and control over the regulatory environment. This breeds the fraud we note in this paper and allows it to thrive. Regulatory agencies might consider placing an examiners in several large member firms to serve as their representatives. However, a maximum term (i.e., two years) would need to be set before returning to the regulatory agency, in accordance with auditor rotation practices, to avoid the influence of the systemic corruption described throughout this paper.

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