Investment Fraud and the Role of Trust

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Investment fraud can happen to anyone, and unfortunately, there is no shortage of investment fraud possibilities. Affinity fraud, pyramid schemes, pump-and-dump security trading, high-return or risk-free investments, and pre-IPO scams are only a few of a long-list of schemes that could separate investors from their hard-earned money.

Investors can find themselves the victims of fraud when they don't do enough due diligence or put too much faith in the people selling or managing a fund. Investors around the world would be wise to grasp fundamentals of the financial services industry, especially since results from a 2016 survey conducted by the National Association of Retirement Plan Participants show that only one in 10 persons express confidence in financial institutions. Financial advisers are similarly viewed with doubt. This is problematic.

Due in part to these concerns, very few people are adequately saving for retirement and those with money frequently invest in riskier assets in hopes of high returns. Following the 2008 credit crisis, people are changing the kinds of assets allocated in their pension plans and foundation portfolios. Taking more risks isn't necessarily bad as long as investors sufficiently understand what is being offered to them and have assurances that sufficient safeguards are in place. Moreover, savers urgently need reliable help. Fragile confidence in the intentions of financial service providers creates a friction that can discourage investors from getting the input they need.

But investment fraud isn't just a problem for individuals. When it occurs, it taints the financial services industry and the professionals who operate with high integrity and put customers first. Low trust of an entire industry can invite additional regulation. The net effect can be unfair penalties that diligent investment stewards must pay for the trespasses of fraudsters.

Increasing Investor Confidence

Although there is no such thing as a risk-free investment, investors can take action to detect red flags and hopefully avoid problems. With the Madoff Ponzi scheme, there were some who seriously questioned whether the touted strategy was legitimate, let alone viable, and did not invest. Regarding Enron, some investors looked askance at the energy company's reliance on a complex web of special purpose vehicles. One lesson learned from the Bayou hedge fund scandal is to verify whether auditors are independent and well respected.

In its guide for seniors, the U.S. Securities and Exchange Commission urges the use of publicly available databases to check the disciplinary history of brokers and advisors, warning that investors should "never judge a person's integrity by how he or she sounds." The guide also says to avoid those who use fear tactics and to thoroughly review documents. The Financial Industry Regulatory Authority cautions investors not to be pressured or to believe that a "once in a lifetime" opportunity will be lost without immediate action.

To help combat investment fraud, the North American Securities Administrators Association teamed up with the Canadian Securities Administrators to create an online quiz that anyone can take to enhance awareness of what to avoid.

Although there are organizations that formally grade companies on their trustworthiness, investors should not rely on a single metric alone. Instead they should study whether a financial service provider has a good reputation in the marketplace and what the company is doing to manage its economic and operational risks.

Financial service companies likewise have responsibilities to be trustworthy and ensure that adequate protections are put in place. Some of these critical action steps include:

- Setting up controls to prevent rogue trading
- Appropriately compensating salespersons to minimize conflicts
- Providing existing and potential customers with clear and understandable investment documents
- Regularly communicating what the organization does well to lower risks for its customers
- Calling out questionable activities of its competitors and working with industry organizations to improve risk management and fraud prevention techniques.

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