



# Cornhusker Economics

## Challenges of Making Financial Decisions and Avoiding Fraudulent Schemes

Last month there was an article in the local newspaper about a man accused of defrauding commodity investors for several years in Nebraska. This person is a commodity pool operator (CPO), who is an individual or organization that operates a commodity pool and solicits funds for that pool. A commodity pool is an enterprise in which funds contributed by a number of clients are combined for the purpose of trading futures contracts, options contracts, among other types of financial products. Generally speaking, a CPO manages an investment fund focused on commodity products.

As the story goes, the Commodity Futures Trading Commission (CFTC), which is an independent agency of the US government that regulates derivatives markets, filed a civil enforcement action against a CPO in Nebraska who has allegedly “solicited approximately \$790,000 from approximately 27 persons to invest in a commodity pool that would use pool funds to invest in exchange-traded commodity futures contracts.” However, the civil action claims that the CPO “failed to invest participant funds and misappropriated more than 80 percent of the pool’s assets,” in addition to “multiple regulatory violations.”

Let us take a closer look at what goes on in this kind of situation and discuss some aspects of it. Before we continue, let us also keep in mind that the market is full of honest commodity pool operators who act on their promises and manage their investment pool according

to all rules and regulations. What we are discussing here corresponds to a few cases that, unfortunately, come up from time to time.

### *How does it work?*

There are different ways in which these frauds are executed, but in general, it involves an individual trying to sell financial services and promising exceptional investment opportunities to their potential clients. Regardless of how it starts, the next step is often the same: the commodity pool operators use their clients’ money for their own expenses or for their own accounts instead of investing it as promised. The commodity pool operator keeps all the money in their own accounts and spends it as they please over time, without making any effort to follow the investment promises made to their clients.

Sometimes it can take a long time until the clients find out about the fraud. As long as clients keep their money “invested” in the pool, the commodity pool operator generates fake account statements that give clients the impression that the value of their investment is growing over time.

Even if some clients decide to take their money back, the commodity pool operator still has a large enough amount of funds and can typically return the money to a few clients at any point in time. In addition, the commodity pool operator is continuously offering their services to prospective investors, hence there are often new

clients sending money to the commodity pool operator.

These fraudulent schemes normally fall apart when a large number of clients decide to take their money back at the same time. The commodity pool operator would not have enough funds to return the money to all those clients at the same time and the fraud would then be exposed.

### ***Why do so many people take the bait?***

In general, this type of fraud starts with a commodity pool operator (or anyone offering financial services) making a sales pitch that normally involves at least some of the following pieces:

- Promise extraordinary profits with low risk
- Claim to have a record of highly profitable trading
- Assure quick and guaranteed profits
- Say that your neighbors (or other people in town, or other investors) have already jumped in
- Claim to know unique trading methods that guarantee large profits
- Create a false sense of urgency as if you had to make a decision right away

These tactics work much more often than we would like to admit, and they are based on how our brain approaches financial decisions. Behavioral finance and neuroeconomics are two fields of research that have grown substantially in the last 40 years by investigating decision-making and using empirical evidence relating to brain activity to explain behavior. Here are some interesting findings from a large body of research conducted in those fields in the last several years.

Anticipating a gain and actually experiencing the gain are expressed in different ways in our brains, which means here that the anticipation of making money feels better than actually making money. We certainly feel good when we are making money, but it does not feel as good as the expectation that it will happen. Research shows that our brains are more aroused with the anticipation of profit than with the actual profit, and also shows that the neural activity of someone experiencing profits is similar to that of someone high on drugs. This gives us a sense of the intensity with which the anticipation of making

profits hits our brains. When we hear promises of large profits and claims of guaranteed returns, our brains make those investment opportunities feel very tempting. The typical sense of urgency that often comes along the sales pitch is essentially an attempt of the commodity pool advisor to take advantage of that strong feeling generated by our brains before we have a chance to think it over.

Another piece of the sales pitch is the claim that “everybody else” is joining the pool and taking advantage of that extraordinary opportunity. Studies in behavioral finance have consistently found what is called “herding,” which means that we like to follow what others are doing. In this case, commodity pool operators take advantage of the following reasoning.:

- If I do not join the pool and they make money, everyone will be laughing at me for missing this opportunity.
- If I join the pool and they lose money, at least I will have made the same mistake that everyone else made.

In other words, if we are going to make a mistake, we would rather be one of many people who made that mistake than be the only one to make the mistake. Of course, this is not a good reason to make financial decisions, but research studies have observed this kind of behavior in several situations.

### ***Avoiding the Trap: Financial Education and “Sniff Test”***

As we are aware of the points discussed above, it becomes relatively easier to try to avoid fraudulent schemes. A good start is to keep in mind that spur-of-the-moment decisions and following what “everyone else” is doing are not part of a well-developed investment. It is also important to be educated about finance.

As we think about some of the typical pieces of the sales pitch that we discussed above, a good financial education would help identify signs of possible fraudulent schemes. For example, they often promise quick, large, and guaranteed profits. These three words (quick, large, guaranteed) do not belong together when we talk about profits. Successful investment strategies that generate large profits are comparable to a marathon, not a sprint race. Besides, with very few exceptions (such as investment in government obligations), there are no guaranteed profits. There is al-

ways risk in investments and one piece of an investment plan is to decide how to manage that risk.

This brings us to another common piece of fraudulent sales pitches: large profits with low (or zero) risk. Large profits and low risk do not come together in our world. If we want to have a chance to make larger profits, this means we need to take more risks. If we prefer to keep our risk low, then we need to accept lower profits. Nobody knows an investment method that guarantees large profits with low risk. Even if someone claims to have a track record showing large profits, they will also have a track record showing high-risk investment strategies. For those who consistently use high-risk strategies, the odds will eventually catch up with them and they will start losing.

As we are well educated in finance, we can use what my former boss used to call “sniff test.” When I started my career in the trading desk of an investment bank, my boss would make initial decisions about trading strategies based on his “sniff test.” He had vast experience in financial markets and a lot of knowledge about finance. When we (his traders) came up with different ideas about trading strategies, he would quickly disregard anything that did not make sense to him right away. He would act as if he was sniffing something and just say “this one didn’t pass the test.”

We do not need to be as experienced and knowledgeable as my former boss was. But even a good understanding of some basic principles in finance can help us identify that, for example, promises of large profits with low risk are a sign of fraudulent schemes.

***Taking the Next Step:  
Ask Around Before You Move Forward***

Even if we find that a given commodity pool operator is worth our time, we still need to do our homework before making a final investment decision. One part of that is to contact the organizations that regulate commodity trading and check the registration status of the commodity pool operator, their business background and also any disciplinary history they may have. We can gather this type of information by contacting the Commodity Futures Trading Commission (CFTC) at 866-366-2382 (in the event the number changes over time, the new number

can always be found in their website, [www.cftc.gov](http://www.cftc.gov)) and the National Futures Association (NFA) at [www.nfa.futures.org/basicnet](http://www.nfa.futures.org/basicnet).

It is also helpful to ask the commodity pool operator for copies of the following documents: account statements provided to them by registered trading firms, risk disclosure documents, and performance history. In addition, we should ask for information about fees and commissions charged by the pool operator, the qualifications of the operator, and how the investment strategy of the pool meets our financial needs or objectives. Honest commodity pool operators will have no problem in providing all these documents and information to us.

***One Final Thought***

Making decisions involving money is never easy and can sometimes lead to stress and disappointment. But some caution and basic financial literacy can go a long way in helping us avoid fraudulent schemes, like the one discussed at the beginning of this article.

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