

# Spooky Trades/Corporate Fraud

An introduction to corporate scandals

# Brainteaser

## Problem:

You and I are to play a competitive game. We shall take it in turns to call out integers. The first person to call out '50' wins. The rules are as follows:

- The player who starts must call out an integer between 1 and 10, inclusive;
- A new number called out must exceed the most recent number called by at least one and by no more than 10. (if first number is 5, the next number can be anything 6 to 15)

Do you want to go first, and if so, what is your strategy?

# Brainteaser

## Solution:

- Winning number must be just out of reach of other player
- 50 -> 39 -> 28 -> 17 -> 6

# Market Update

- Eurozone - draghi came out with a more dovish tilt on the announcement regarding their QE program
- Fed – Chairman still up in the air, but Powell is expected as of now
- 19th party congress – People looking at to see what will happen with China going forward

# Fraud

What is fraud?



# Death Arbitrage

- Initially designed as an estate planning tool
- If one joint-owner dies, the other is able to redeem the bond at par
- Death put option on bonds + terminally ill patients = arbitrage
- Banks would get mad and refuse to redeem to a hedge fund
- “Fair exploit of a wall street loophole”

# Ponzi Scheme



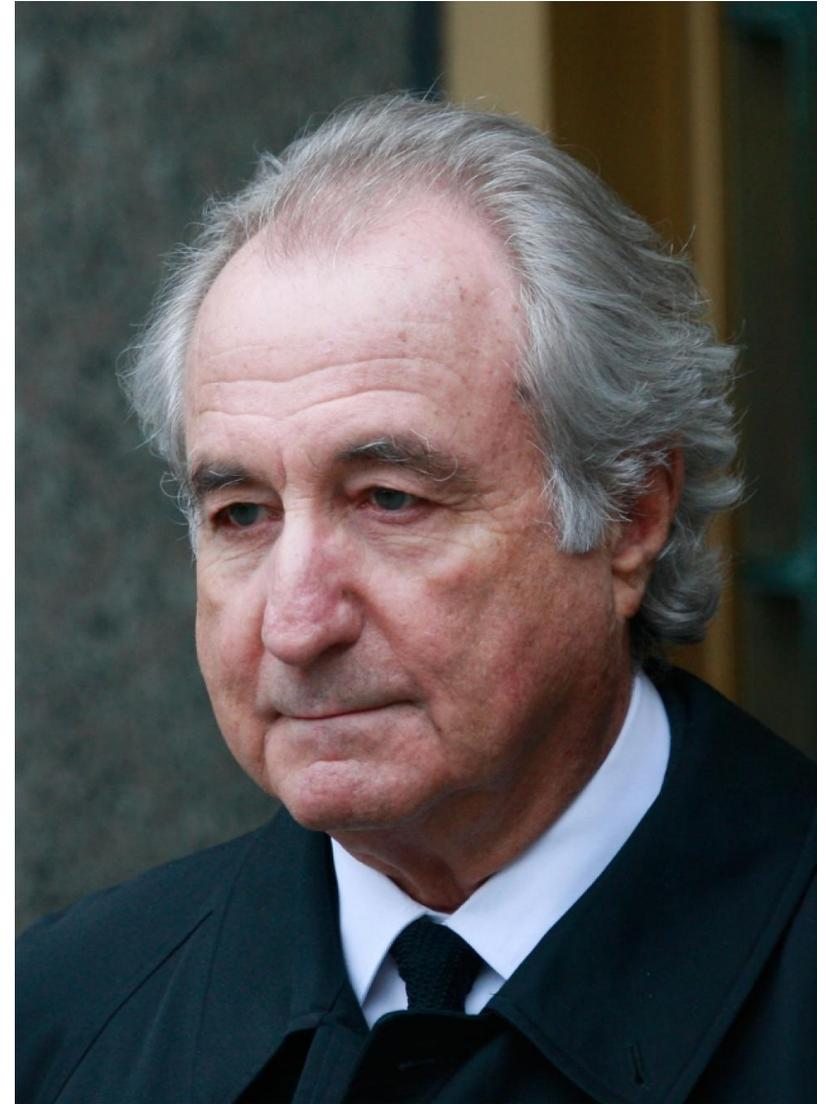
- Old investors are (falsely) told about great returns, while new investors' capital is used to fulfill old investors' capital withdrawals as needed
- Essentially robbing Friend A to pay Friend B
- Works until the money runs out

# Original Ponzi Scheme

- Named after Charles Ponzi for his postal stamp arbitrage
- Buy stamps cheap in Italy and exchange them for a higher value in the U.S.
- Promised 50% profit in 45 days or 100% profit in 90 days
- Required titanic sized ships to actually deliver promised profit
- Would not work today...

# Bernie Madoff

- Most famous Ponzi scheme
- Madoff exhibited unrealistically steady returns of ~10% for decades
- It all came crashing down when the SEC acted on tips from suspicious wealth managers
- Ended up stealing \$20 billion from clients, that he claimed was worth \$65 billion



# Enron

## Accounting Fraud, Lies, Assholes

### Accounting Issues / Earnings Manipulation

- Revenue Recognition Fraud
- Downfall of Arthur Andersen
- Earnings Targeting Rather than Operations Targeting

### Aggressive Culture but a Market Darling

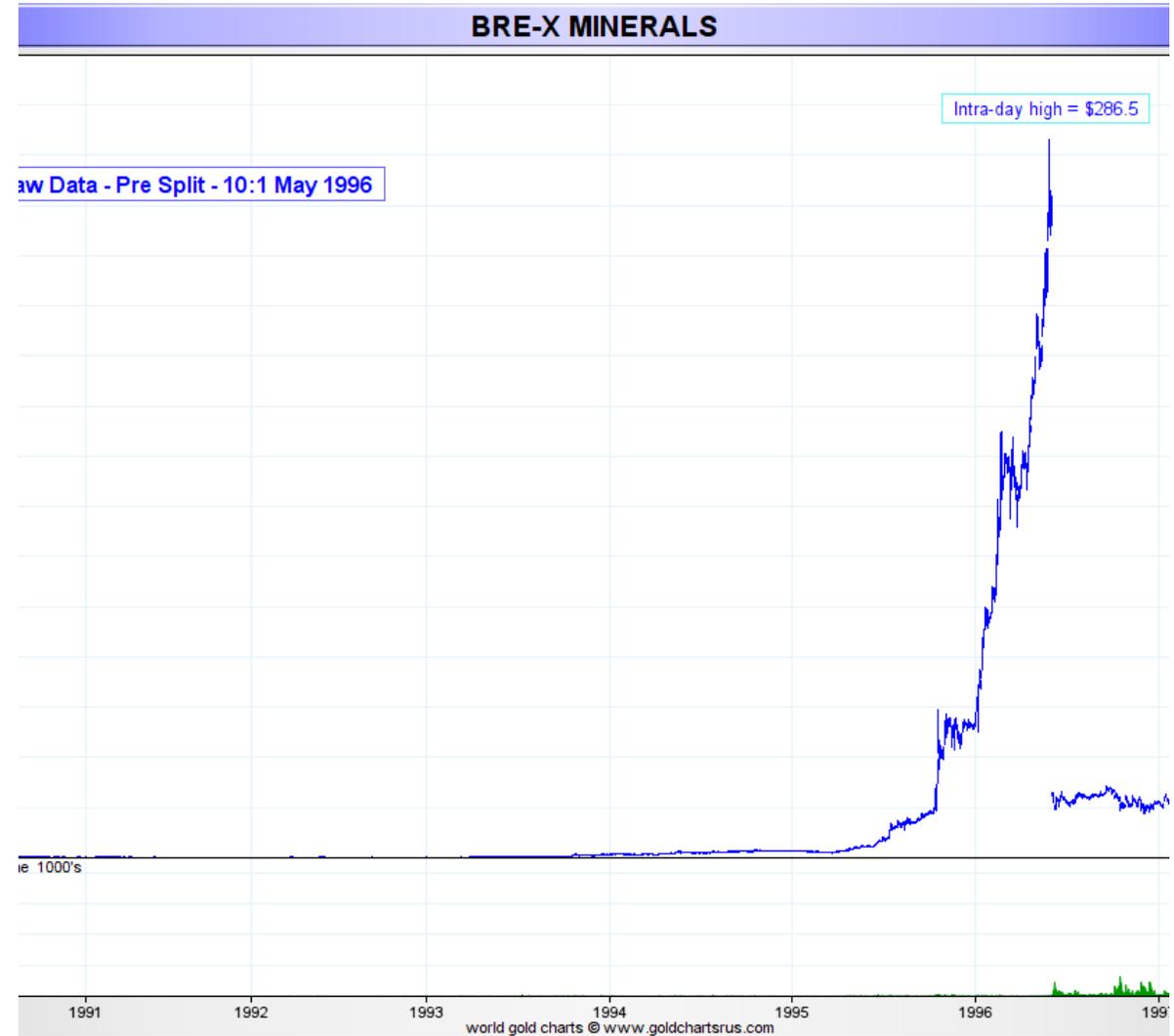
- Accusations / Critics all ignored
- Debt paydown to reassure everyone (but nobody noticed that they used more debt to do it)
- Dynegy intervention?

Enron Stock Price from August 23, 2000 to January 11, 2002



# Bre-X

- Penny stock CEO is convinced to invest in Indonesian mine by two geologists
  - One of whom has 5 independent wives who know nothing about the others
- Crushed core samples used to continuously drive up gold reserves in land
  - “nugget effect” used as justification
- Junior geologist confusion at core samples lying around open and due diligence from competitors
- Indonesian government revokes Bre-x license, enters split deal with Freeport-McMoRan to begin excavation
- Freeport finds 0.01 g/tonne vs promised 4.39
- Equity research clueless throughout this process
  
- Helicopter death, robbery, torture, everyone gets away with it but the lawyer



# Salad Oil Scandal

## The Culprit Behind the Scandal



### Anthony "Tino" De Angelis

- Con-man at young age – as a teenager he worked in meat market managing 200 employees. He overcharged government under National School Lunch Act and delivered 2 million pounds of uninspected meat.
- Takes advantage of government programs through Salad Oil Scandal, stashed money in Swiss Bank Account.
- Then Jailed for 7 Years – after release Tino becomes involved in Ponzi Schemes.

# Salad Oil Scandal

## De Angelis' Scheme to Swindle the Government

### Step 1: Started Allied Crude Vegetable Oil Refining Co.

- In 1955, company was created to take advantage of US Government's Food for Peace program. Goal of this program was to sell surplus commodities to Europe at low prices.

### Step 2: Corner Soybean Oil Market

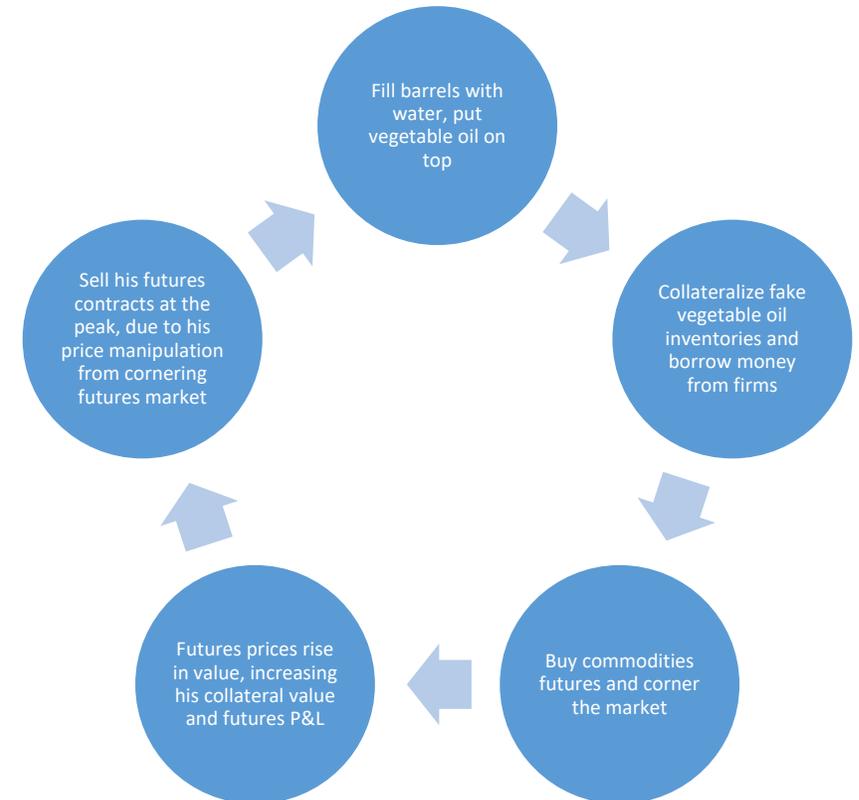
- Plan to use his large inventories of commodities as collateral to get loans from Wall Street Banks and finance companies. Buying soybean futures would drive up price of his vegetable oil holdings, which increases value of inventories and allow him to profit from his future contracts.

### Step 3: Lie

- American Express gives loan to De Angelis. AmEx created a division that specialized in field warehousing, which gave De Angelis receipts for millions of pounds of vegetable oil. De Angelis takes receipts to brokers and discounts receipts for cash. De Angelis falsifies warehouse receipts for vegetable oil he didn't have.

### Step 4: Lie More

- Unsatisfied with the American Express loans, De Angelis was able to get additional loans from Bunge Ltd., Staley, Proctor and Gamble, and The Bank of America. By the time the swindle collapsed, De Angelis had gotten loans from a total of 51 companies.



# Salad Oil Scandal

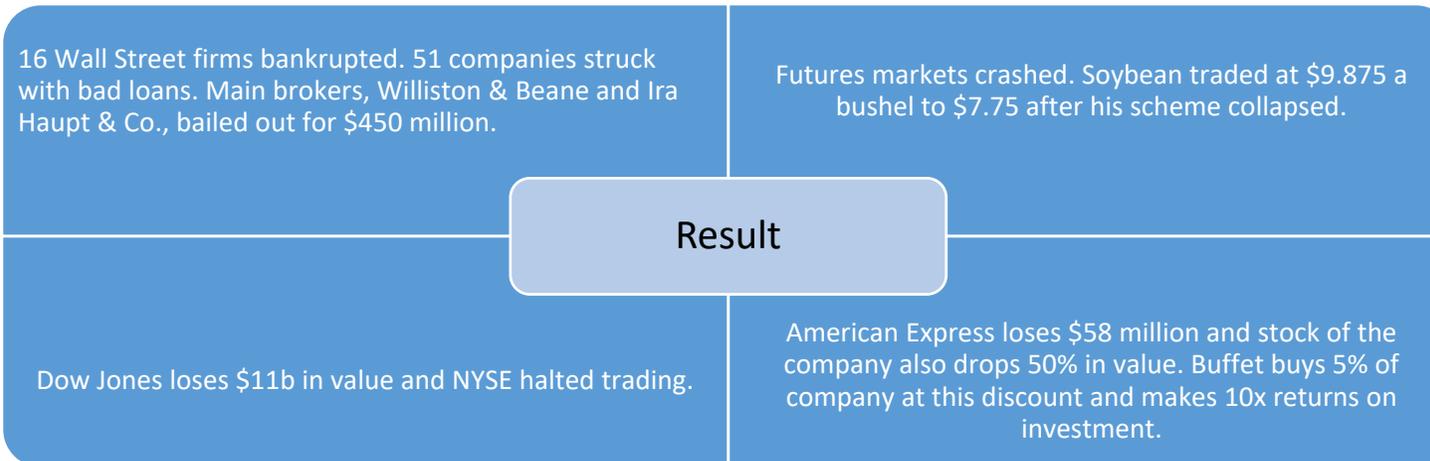
## Didn't even try to hide his fraud

### 1. Tanks filled with water not oil

- Tanks were filled mostly with water with a minimum of oil floating on the top to fool the inspectors, or that some of the tanks were connected with pipes to other tanks so the oil could be transferred between tanks when the inspectors went from one tank to the other.

### 2. USDA Inventories

- The receipts and reported inventories that De Angelis had were more than the entire United States inventories as reported by the USDA.
- Only had \$6 million of the \$150 million collateral.



# Sino-Forest Corporation

## Sino-Forest

- Sino-Forest is a Canadian company claimed to be one of the top commercial forest plantation operators in China with \$3 billion in timber assets

## Muddy Waters

- In 2011, Muddy Waters Research released a report alleging that they had fraudulently inflated their assets and earnings

## Ponzi Scheme

- They claimed it was a “multibillion dollar Ponzi scheme” that was “accompanied by substantial theft”



# Sino-Forest Aftermath

## Aftermath

- After the report, shares fell 82%, Paulson sold his entire stake, and S&P downgraded their credit rating

## OSC

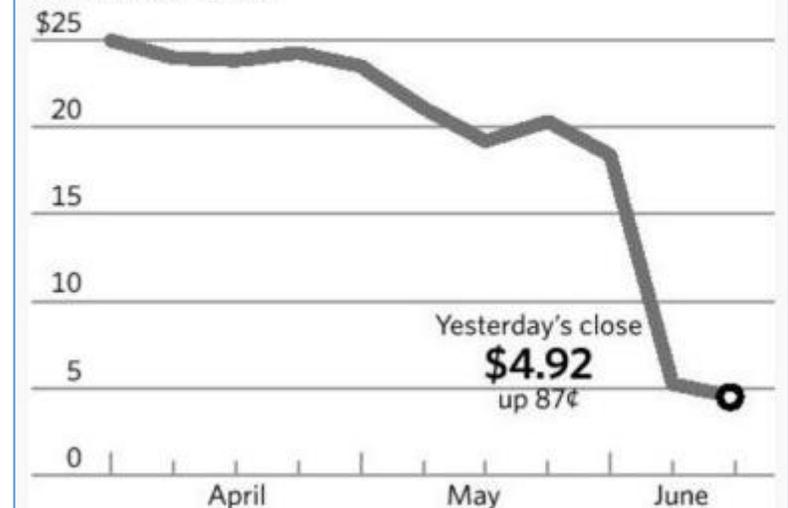
- Ontario Securities Commission's investigation had trouble verifying company assets and alleged that Sino-Forest falsified ownership and documentation of those assets

## Bankruptcy

- In 2012, Sino-Forest Filed for bankruptcy protection in Canada and all assets were handed to debt holders

## Sino-Forest Corp.

TSX WEEKLY CLOSE



SOURCE: Bloomberg

# Let's Gowex – A Big Fraud

## A Spanish Tech Company Worth \$0



### Summary of Fraudulence

- Overstated earnings by 10x – actual revenues were 10% of what was reported in financial statements
- Owns 5k networks – CEO stated that company owned 100k
- Audit fee was \$40k, which only makes sense if actual revenues were 10% of what was reported.
- 90% of revenues were from undisclosed related parties, tied to the CFO and an early investor. AKA Gowex's largest customer was itself
- Gowex told investors that NYC pays Gowex 7.5m. Real number was 200k.
- Head of IR was CEO's wife (she signed off on GOW's annual reports), and CEO previously was a director at a penny stock fraud company.

# Gotham City Research – The Fraud Finder

Research group who figured out Gowex was a fraud.



## Summary of Gotham City Research

- Companies suspected of large-scale fraud are brought to justice by attempting to drive down their share price through the publication of critical financial reports and short positions in its stock.
- Within days of alleging that Gowex, a Spanish wi-fi provider, had cooked its books, the company **admitted it was bankrupt** and four years of accounts were worthless.
- Gotham's superhero image has been enhanced by a refusal to reveal any details about its identity, other than the name of its founder – Daniel Yu.

# Comeback Story of Barry Minkow

1. Carpet cleaning
2. Insurance restoration business and appraisal company
3. Organized crime, jewels thieves as sources of funding
4. IPO, fake offices, fake contracts
5. Merger with legitimate business to save the day
6. Unpaid homemaker assembles angry victims right before deal closing
7. Deal financing pulled, unaudited press release fails
8. Born-again Christian -> Pastor
9. Book sales of story went to paying back the victims of fraud
10. Uncover 1 BN USD of fraud in career and even saves his church endowment from a pyramid scheme

# Just Kidding

- Fraud investigations would also have short positions put up on non-public information
- Stole 3 MM from Church
  - “widower who gave \$75,000 to fund a supposed hospital in Sudan to honor his wife after she died of cancer”
- antisocial personality disorder, narcissistic personality disorder, attention deficit hyperactivity disorder, anxiety disorder, opioid dependence, anabolic steroid abuse, and migraine headaches.