

Fraud Considerations in Institutional Investing

PRESENTED BY: THE IMDDA





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- What is investor fraud, and what theories underpin its occurrence?
- What are some types & categories of investor fraud schemes?
- Background on recent financial fraud cases, including:
 - Wirecard
 - 1MDB
- Identify red flags or indicia of fraud

Background on Fraud

- Black's Law Dictionary

- *A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.*



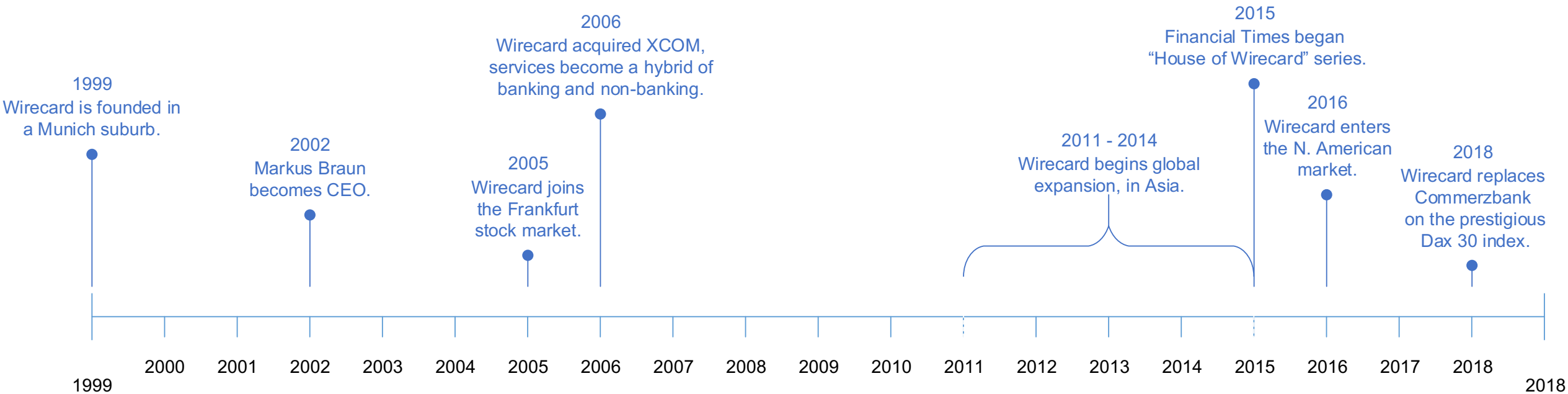
The Fraud Triangle
Other People's Money
Donald Cressey, 1973

- ACFE definition
 - Deceptive practices in the purchase or sale of securities, covering a broad range of illegal activities.
 - Securities are fungible, negotiable financial instruments that represent an interest or right in something else.
- FBI
 - Investment fraud involves the illegal sale or purported sale of financial instruments. The typical investment fraud schemes are characterized by offers of low- or no-risk investments, guaranteed returns, overly-consistent returns, complex strategies, or unregistered securities.

Advance fee fraud	“Footing the bill for a speculative investment”	ICO / Digital Currency Scams	“Stable investing in a volatile world”
Ponzi schemes	“Robbing Peter to Pay Paul”	Financial	Monetary losses
Market manipulation fraud	“Pump and dump”	Reputational	Loss of trust / confidence from participants
Technology-based Schemes	“The robots do it all”	Operational	Brain drain / systems redesign
Pre-IPO Investment Scams	“Getting in before it goes big”		

Case Example - Wirecard

Wirecard, which offers electronic payment transaction services, risk management as well as physical and virtual cards, had its stock price collapse on June 25, after it was discovered that Wirecard was involved in a sophisticated global fraud.



Over the years, there were complaints against Wirecard regarding accounting irregularities, money laundering, market manipulation and inaccurate representations to investors. In 2019, Media reports and whistleblowers alleged the company had faked its sales transactions to inflate revenue and profits. The company denied all claims.



Wirecard owes its creditors around €3.5 billion.

Prosecutors are investigating the former CEO and others on various charges.

Wirecard: from stock market star to scandal

Share price (€)



Source: Refinitiv
© FT

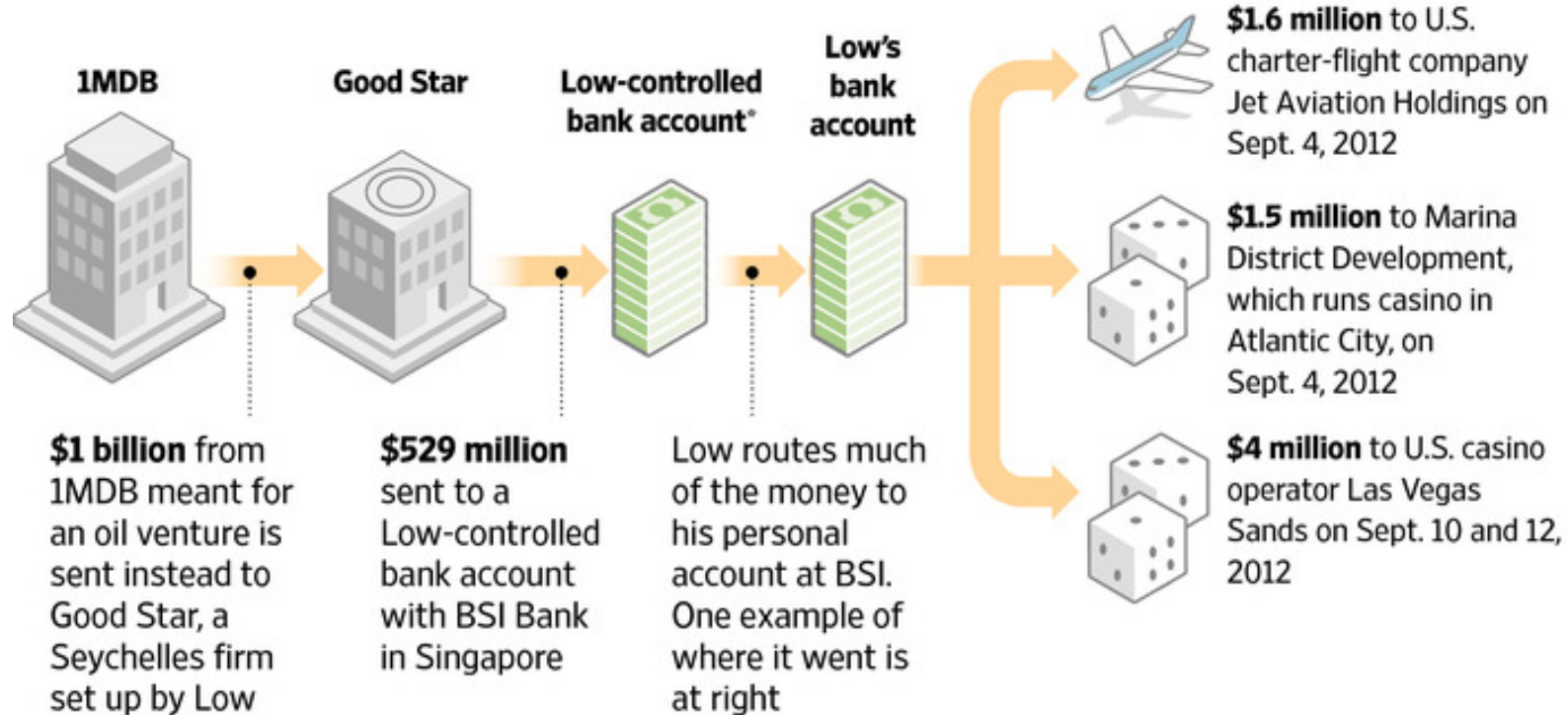
- Regular accusations of improper/illegal behavior over multiple years
 - Despite Wirecard consistently denying accusations, often, where there is smoke, there is fire
- Company structure that encouraged investors to rely on Wirecard's adjusted financial statements
 - Wirecard's structure (a combination of banking and non-banking services) made it difficult for investors to compare it to peer companies.
- Consistent increase in interest-bearing debt, from less than €100m at the end of 2014 to more than €1.5b by end of 2018
 - Less than 5% of total assets in 2014 to more than 25% at end of 2018

Case Example – 1MDB

- Beginning in 2008, Najib Razak, the former Prime Minister of Malaysia, established a wealth fund to benefit his country, now widely known as 1 Malaysia Development Berhad, or 1MDB.
- The fund was meant to invest tax payer money overseas and generate large returns to benefit the people of Malaysia and spur the country's economy.
- Jho Low, advisor to Najib at the time, allegedly targeted 1MDB as his “whale,” or a major investment fund for him to use at his liking. He became Najib's advisor.
- 1MDB received funding through loans and bond offerings involving Goldman Sachs.
- While some funds were used for their original intended purpose, much of the money was allegedly sent through the accounts of various shell companies, banks and individuals and ended up in the pockets of Najib, Low and other powerful individuals.

Funds Rerouted

Hundreds of millions of dollars from Malaysian fund 1MDB landed in accounts controlled by financier Jho Low. Here is how one set of transactions worked.



*Account of Abu Dhabi Kuwait Malaysia Investment Corp.

Sources: Global investigations; Malaysian parliament; Singapore police report; people familiar with the matter THE WALL STREET JOURNAL.

Malaysia Money Trail

Global investigators believe \$681 million entered Malaysian Prime Minister Najib Razak's account from state fund 1MDB via a web of foreign entities, contradicting an account by Malaysia's attorney general.

ACCORDING TO MALAYSIA'S ATTORNEY GENERAL



Saudi royal family member

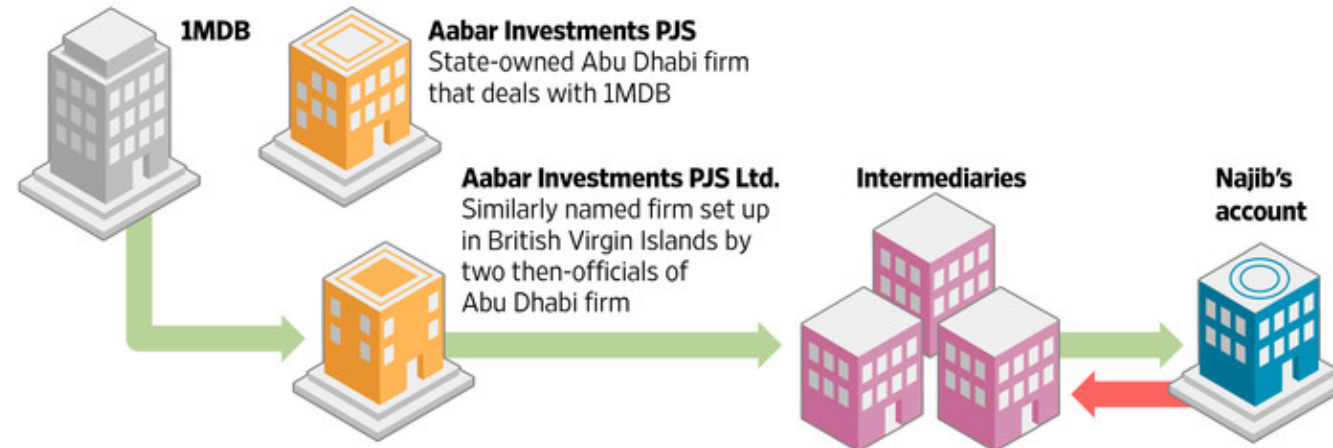
Saudi royal family member sends **\$681 million** as a legal 'personal donation.'



Najib's account

AG says most of the money is returned.

ACCORDING TO INVESTIGATORS IN TWO COUNTRIES



Nearly \$2.4 billion from 1MDB, meant for Aabar Investments PJS, flows instead to Aabar Investments PJS Ltd.

\$681 million of the money passes, via intermediary firms, to Najib's account. Most is later returned to intermediaries.

Sources: Malaysian Attorney General; people familiar with investigations

THE WALL STREET JOURNAL.

- Najib's campaign for re-election after the scandal was a failure. In July 2020, he was found guilty of criminal charges for money laundering, criminal breach of trust and abuse of power by the Kuala Lumpur High Court.
- Najib was sentenced to 12 years in prison and fines of \$50 million. He will face four additional trials for his part in 1MDB.
- Jho Low faces charges in Malaysia and the United States and is currently a fugitive at large.
- Goldman Sachs employees faced criminal charges in Malaysia and the United States because of their alleged involvement in the 1MDB scandal.
- On July 24, 2020, Goldman Sachs reached a settlement with the Malaysian government for \$3.9 billion.

- A review of 1MDB's financials would have revealed suspicious activity
 - Inexplicable layering transactions
 - Financial transactions around the world, including areas with amounts of high money laundering
 - Round trip transactions between entities and government
- The fund was unable to maintain a consistent auditor
 - Three "Big Four" accounting firms resigned in succession: Ernst & Young resigned (2009), then KPMG resigned (2012), and then Deloitte resigned (2016)
- The Chairman of the Board of Directors abruptly resigned, a few weeks after another director had resigned
 - There was significant staff and executive turnover and many who worked there had little experience

- 1MDB held an account at a small, struggling Swiss bank, BSI, where 1MDB was its largest client
 - The bank was dependent on 1MDB's business and did not take compliance seriously
 - Goldman professionals pointed out that it was unusual to make such a large (\$3 billion) deposit at a small private bank
- Jho Low was inexperienced, yet was advising Najib and effectively running the 1MDB fund
 - Goldman's compliance department could not determine how Mr. Low had obtained his wealth and stated the bank should not do business with him personally
- The amount of money Goldman Sachs received in commissions for straightforward bond deals
 - Over 10 months, Goldman received almost \$600 million for issuing \$6.5 billion of bonds—about 9%—which was over 200x the normal fee

Red Flags and Analysis Methods

- Impressive, yet oddly stable, historical performance or financial projections
- In-bred governance structure
- Very high level of spending
- Unusual background of executive leadership
- Concerns voiced by former employees / analysts / regulators
- Issues with licensing, registration, or other securities regulatory matters
- Lack of sophisticated internal controls / financial reporting function

BALANCE SHEET	<i>Vertical Analysis</i>				<i>Horizontal Analysis</i>	
	<u>Year One</u>		<u>Year Two</u>		<u>Change</u>	<u>%Change</u>
Assets						
Current Assets						
Cash	45,000	14%	15,000	4%	(30,000)	-67%
Accts Receivable	150,000	45%	200,000	47%	50,000	33%
Inventory	75,000	23%	150,000	35%	75,000	100%
Fixed Assets (net)	60,000	18%	60,000	14%	-	0%
Total	<u>330,000</u>	100%	<u>425,000</u>	100%	<u>95,000</u>	29%
Acc'ts Payable	95,000	29%	215,000	51%	120,000	126%
Long-term Debt	60,000	18%	60,000	14%	-	0%
Stockholder's Equity						
Common Stock	25,000	8%	25,000	6%	-	0%
Paid-in Capital	75,000	23%	75,000	18%	-	0%
Retained Earnings	75,000	23%	50,000	12%	(25,000)	-33%
Total	<u>330,000</u>	100%	<u>425,000</u>	100%	<u>95,000</u>	29%

INCOME STATEMENT	<i>Vertical Analysis</i>				<i>Horizontal Analysis</i>	
	<u>Year One</u>		<u>Year Two</u>		<u>Change</u>	<u>%Change</u>
Net Sales	250,000	100%	450,000	100%	200,000	80%
Cost of Goods Sold	125,000	50%	300,000	67%	175,000	140%
Gross Margin	125,000	50%	150,000	33%	25,000	20%
Operating Expenses						
Selling Expenses	50,000	20%	75,000	17%	25,000	50%
Administrative Expenses	60,000	24%	100,000	22%	40,000	67%
Net Income	15,000	6%	(25,000)	-6%	(40,000)	-267%
<i>Additional Information</i>						
Average Net Receivables	155,000		210,000			
Average Inventory	65,000		130,000			
Average Assets	330,000		425,000			

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BALANCE SHEET	<i>Vertical Analysis</i>			
	<u>Year One</u>		<u>Year Two</u>	
Assets				
Current Assets				
Cash	45,000	14%	15,000	4%

- Trust, But Verify
 - Review reported performance and forecasts of individual investments with industry sources, colleagues, or any non-investee prepared information
 - Seek out weaknesses in specific elements of the business and inquire about them
 - Gain understanding of true peer companies or comparisons between other industry players
- Don't Invest in What You Don't Understand
 - Either forego investments in highly complex businesses or industries, or *get a solid foundation in those topics* before investing
- Time Heals All Wounds
 - Consider the timing of an investment solicitation; urgency is often a leading indicator that the strategy may not be legit



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