

Collateralization of Artificially Inflated Stocks as a Way of Generating Profit – “Clean Cashback”

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Abstract. The issue of enrichment through artificially inflated stock prices has become especially significant in the past decade due to the increasing number of lawsuits filed against various publicly listed companies. The purpose of this study is to thoroughly examine the income generation process resulting from the collateralization of artificially inflated stocks and to assess the possible profitability of this operation for all parties involved. The research hypothesis is the possibility of an income-generating scheme based on the process of depositing overvalued securities of companies under securities-backed lines of credit offered by financial institutions around the world. The essence of the research procedure is a step-by-step study of two processes: capital round-tripping as a means of stock price inflation, and subsequent pledging of shares for a line of credit, and the application of the DuPont formula to calculate return on investment. The main results indicate that the potential beneficiary's cashback could reach approximately 180% of the initial investment, subject to a four-fold increase in share price. Bank profitability ranges from 28.6% in the worst-case scenario to around 80% in the best case scenario for this credit transaction. The theoretical and practical significance lies in the introduction and definition of the term “Clean Cashback” for scientific research, the visualization of the income generation process, and the development of a methodology to calculate profitability for all participants involved. One additional avenue for future research is examining the stock market's reaction to the collapse of inflated stock prices, considering the time lag before margin calls.

Key words: clean cashback; securities-backed line of credit; capital round-tripping; return on investment; foreign direct investments; market manipulation; margin call.

JEL G11, G12, G14, G15

1. Introduction

The capital round-tripping (CRT) process is not new and has been actively studied by various groups of scientists for many years. However, the idea of sky-high stock valuations as a result of the process described deserves special attention because it is essentially a fraud scheme that may have negative consequences for the financial market as a whole. The company's shares appear to be strongly overvalued, and sooner or later, their prices start to decline rapidly. Promoters may use entities based

in offshore jurisdictions to evade disclosure requirements related to promoter (insider) shareholding, which makes manipulations of the stock prices of listed companies possible.

In addition, the company uses a specific instrument to obtain income: it pledges shares of its inflated stock for loans.

A logical question arises: is there any way to determine whether the company is involved in the processes described above? An indicator of a company's massive use of securities-backed lines of credit (SBLOC)

is that it becomes deeply overleveraged. However, this can only be detected through a detailed study of a company's financial statements. Maintaining elevated leverage may be justified by the company's various plans, such as its expansion plan. It is important to note that there is a practice of breaching certain debt obligations, because of which lenders could declare an event of default, accelerate repayments, or trigger cross-defaults on other arrangements. If no additional collateral is available, the lender could require the forced liquidation of shares (margin call).

Paradoxically, the borrowing company benefits from this because liquidation is in fact part of a well-planned and well-thought-out fraud scheme. Another indicator could be that this company is a family business that is largely controlled by family members, creating a ripe environment for unilateral and non-transparent financial decisions.

The study of this process is relevant at the present time in connection with the investigation of the largest con in corporate history "allegedly" pulled by Adani Group¹. This is not the only case of accounting fraud, stock manipulation, decadence, and money laundering in Adani taking place over the course of the last decades. For instance, according to the Hindenburg research report, Icahn Enterprises also follows that road as far as its stocks may be overvalued and pledged for margin loans².

In recent years, algorithmic-based market manipulation with stock price has considerably increased, and it is difficult to identify all such manipulation cases. This causes serious challenges for market regulators. Some authors compile different indicators for detecting

manipulation in the stock market, utilizing the perspectives of return rate, liquidity, volatility, market sentiment, closing price, and firm governance [1].

In addition, findings by some scholars suggest that the frequency and magnitude of stock market manipulation increase during periods of natural disasters [2]. Thus, the problem is currently exacerbated by the occurrence of many natural disasters around the world, including floods, earthquakes, droughts, landslides, and forest fires.

The hypothesis of our study is the possibility of an income-generating scheme based on the process of depositing overvalued securities of companies under securities-backed lines of credit.

The purpose of this study is to explore in detail the income generation process resulting from collateralization of artificially inflated stocks and to determine the possible profitability for all participants involved.

This goal predetermined the following *tasks*:

1) Description of the process of capital round-tripping to offshore financial centers (OFCs) and back in the form of foreign direct investments (FDI).

2) Description of the securities-backed lines of credit mechanism.

3) Visualization of the general scheme of income generation for an individual company as a result of both processes described with the introduction of the new term "clean cashback".

4) Calculation of several indicators reflecting the suspected profitability of the scheme under consideration for both the beneficiary company and the commercial bank.

As a scientific novelty, we can highlight the development of methods for assessing the possible gain of the company because of using loans against the pledge of inflated shares ("Clean Cashback") and for calculating the related bank profitability.

Note that it is not possible to calculate the financial effects based on specific

¹ Adani Group: How the World's 3rd Richest Man Is Pulling the Largest Con in Corporate History. Hindenburg Research. January 24, 2023. Available at: <https://hindenburesearch.com/adani/>

² Icahn's Latest Disclosures Raise Critical New Questions About Margin Loans, Continued Portfolio Losses. Hindenburg Research. May 11, 2023. Available at: <https://hindenburesearch.com/icahn-response/>

data for individual companies; therefore, in this article, we provide an approximate calculation of the financial effects for both the beneficiary company and the commercial bank.

The content of the article is structured as follows. At the beginning we describe in detail the process of CRT, considering its possible consequences and examples of the use of such practices by various companies. Then we answer the question: What is an SBLOC? We also spell out its main benefits for the client and examine this process using the real-life example of J.P. Morgan Chase (JPM). The maximum SBLOC rates outlined in The Bancorp’s Commitment Letter are also presented here. After, based on the graphical

method (data visualization method), we present the income generation process, which includes both previously described processes. Then we develop the author’s methodology for calculating the potential gains of the beneficiary and the bank. Return on investment (ROI) analysis is the foundation for our calculations. The ROI measure, or DuPont formula, was developed and expanded by Donaldson Brown in 1914 [3].

2. Literature Review

The scientific literature contains numerous studies dealing with round-tripping FDI. The problems and ways to address them presented in the current literature are summarized in Table 1.

Table 1. Overview of existing research on capital round-tripping and its relationship with OFCs and FDI

Author/source	Problematic issues	Results
Päivi Karhune et al. [4]	Presently, there is little discussion of the ethical implications of such round-trip FDI activities.	Conceptualization of round-tripping as institutional arbitrage, identification of determinants, and ethical implications of investments in OFCs. The authors found that there is greater demand for OFCs that offer a combination of tax and secrecy, or secrecy and property rights arbitration capabilities. They also indicated that deeming OFC investment as unethical behavior is too narrow an explanation in the case of an emerging economy round-tripping, because such investments may in fact provide benefits to society.
Macroeconomics and Fiscal Management Global Practice Group. Dilek Aykut et al. [5]	There is a dearth of research into what kind of legislative measures should be taken to reduce round tripping activity and mitigate its effects in developing countries.	The authors reviewed in detail several well-documented cases of round-tripping corridors in emerging and developing countries and paid special attention to Russia. They revealed that the most important policy measure to reduce round-tripping activity and mitigate its impact is to improve the business environment inside the country for all firms. This can foster domestic and foreign investment and may, to some extent, also curb foreign direct investment round-tripping. They suggested while all indirect foreign direct investment flows be closely monitored, something that is best conducted in cooperation with international partners.

Продолжение табл. 1

Author/source	Problematic issues	Results
Overseas Development Institute. Paddy Carter [6]	Few scholarly studies have examined the implications of banning the use of OFCs as a destination for development finance institutions' (DFI) investments on behalf of developing countries.	Formulation of consequences of the possible refusal of DFIs to direct their investments through the OFCs, such as minor impact on the taxing rights of developing countries and the quantity of investment that DFIs can conduct in developing countries. It was recommended that DFIs find ways of using OFCs for their non-tax merits without obtaining tax benefits. The best solution would be for all countries to review and renegotiate their bilateral tax treaties and their domestic legislation governing the taxation of foreign investors. DFI shareholders can provide technical assistance here.
Xiao Geng [7]	Few studies include a country-specific assessment of the scale of such a new form of FDI as 'round-tripping' FDI.	The author provided one of the very few estimates of the magnitude of this form of FDI to the People's Republic of China (PRC) and suggested it is most likely around 40% of recorded flows. Estimation was conducted based on the data from six source regions, which have published their own independent statistics on FDI to the PRC. Motives for round-tripping in the case of PRC are explored, and it is suggested that these extend beyond the receipt of tax breaks and encompass efficiency concerns.
Svetlana Ledyeva et al. [8]	Insufficient study of various factors that determine the fraction of round-trip investment in total foreign investment into different territories.	The authors examine differences in round-trip investment strategies for firms of different sizes operating in different industries. It was found that the share of round-trip investment in total foreign investment is significantly higher in corrupt and resource-rich regions of Russia than the share of genuine foreign investment. Moreover, round-trip investors, compared to genuine foreign investors, are more reluctant to invest in regions with a higher level of skilled labor and use seaports. This fact indicates that round-trip investment is less technologically advanced.
Svetlana Ledyeva et al. [9]		Based on empirical analyses, it was concluded that the two main determinants of round-trip investment are onshore corruption and offshore secrecy.
Daniel Haberly, Dariusz Wójcik [10]		Geographical, historical, and political factors determining offshore FDI were identified. The authors demonstrated that offshore FDI is equally likely to occur in both developed and developing economies. From a historical

Окончание табл. 1

Author/source	Problematic issues	Results
Daniel Haberly, Dariusz Wójcik [10]	Insufficient study of various factors that determine the fraction of round-trip investment in total foreign investment into different territories.	perspective, the paper shows that offshore FDI links are particularly strong between former and current colonies and their metropolises. Politically, a hierarchical organization of offshore finance emerged, in which some OFCs of the Organisation for Economic Co-operation and Development (OECD) became the main beneficiaries and the weakest and most marginal OFCs became the main losers.
Jason C. Sharman [11]	Compliance with the prohibition on anonymous shell companies' participation in global financial and banking networks is not yet fully understood.	The data presented here suggests the possibility that small island offshore centers have standards of corporate transparency and disclosure that are higher than in large OECD countries such as the United States and the United Kingdom. Rules prohibiting anonymous organizations from using the international banking system are better enforced in those countries.

Source: Author's Own formulation

All existing publications on the effects of FDI can be divided into three groups, depending on the attitude towards the FDI phenomenon in general.

Earlier publications focused on the fact that FDI can have a positive effect on the volatility of stock prices and that the fraudulent financial and tax practices that may be behind such investments, common among large multinationals, are either undiscussed or unknown.

For example, López-Duarte & García-Canal [12] found that the stock market's response to FDI depends on the interaction between the entry mode and location of the investment, the investor's personality, and the investor's international experience. “It will be observed that the average abnormal return associated with FDIs is 0.27 % on the day of the announcement (99 % statistical significance), although such an average abnormal return reaches 0.39 % in some accumulation windows” [12, p. 407].

Alawi [13] considered the volatility of stock prices in the Saudi market a dependent variable. The results show that foreign direct investment had a positive effect on

stock price volatility (coefficient value = 0.001).

More recent publications have focused on identifying cross-country flows with the largest round-trip investments, using statistics on inflows and outflows of direct investments around the world.

For instance, Afrăsinei [14] determined that two of the top three countries with the largest amount of direct investment were the Netherlands and Luxembourg. Many offshore jurisdictions have a higher level of direct investment than some G8 countries. Moreover, the results are similar for both inflows and outflows of direct investment, which means that there is a round tripping of capital.

It was found by Repousis et al. [15] that the movement of huge amounts of capital into or through the Cypriot financial system is a phenomenon that has not been eliminated despite apparently numerous and varied legislative provisions and initiatives. Illegal capital outflows have increased over the years. Russian investors, as key fund-transporters in Cyprus, have intensified tax evasion using methods such as round-tripping, especially after

the Russian “de-offshorization” law came into force on January 1, 2015. The Cypriot financial system, with its ability to create companies with trust status, low taxes, and the “discretionary” behavior of its lending institutions, has an enabling environment for the phenomenon described.

The third group of publications is the most recent, whose authors tend to denounce the downsides of FDI when looking at pass-through or phantom investment, with signs of round-tripping in secrecy jurisdictions.

Mantilla [16] analyzes some aspects of FDI in terms of illicit financial flows and concludes that “FDI round-tripping can be a mechanism used by high-net-worth individuals to benefit from FDI incentives, encourage capital flight, and exert political power over economic policy decisions to obtain greater profits” [16, p. 41].

Couet [17] supposes that round-tripping investors should not be entitled to the treatment afforded to foreign investors under the Investment Laws and Investment Contracts. In some circumstances, round-tripping investments may provide a host state with positive effects normally associated with typical FDI. These rare cases are no reason for investment laws to provide round-tripping investors with the protection afforded to foreign investors.

The next block of publications relevant to the topic of our study are publications on market manipulation in general. Note that in these publications, the process of market manipulation does not necessarily involve the withdrawal of capital abroad and its subsequent entry into the country. These studies predominantly consider the overpricing of shares because of circular trading a significant number of shares to artificially increase prices.

Market manipulation became widespread as an object of scientific research in the 1980s and 1990s. Among the earliest publications on the subject, we can single out the work of Poser [18]. It was mentioned in his study that stock market manipulation was a severe felony at least

as far back as the eighteenth century, and it still happens today. It is a significant infraction because, by manipulating the public’s perception of the value of securities, it undermines or destroys the integrity of the markets. Thus, manipulation may not only defraud investors by tricking them into purchasing or selling assets at fictitious prices, but it may also harm markets in much more extensive ways.

Cherian & Jarrow [19] considered types of market manipulation trading strategies, backing it all up with models and concrete examples. They have also briefly illustrated the possibility of additional market manipulation in the derivatives markets.

Masciandaro [20] raises the issue of eliminating market manipulation through the adoption of new regulations. In his view, the main challenge is that lawmakers must choose between protecting the economy by implementing effective regulations and not burdening financial institutions too much with the cost of compliance. The strictness of regulation depends on how much damage money laundering causes and how much it costs to regulate.

Among the more recent publications is that of Lazonick [21], who postulated that the rationale frequently presented to support open market repurchases contradicts factual evidence and logical reasoning. Corporate executives frequently contend that share repurchases represent investments in undervalued securities, functioning as measures of investor confidence in the company’s future based on the success of its stock price. Because it doesn’t participate directly in the trade but instead has an intermediary manage the buyback transaction, a shell firm may benefit from this aspect. However, when the money is removed from the national economy’s circulation, the damage is actually more severe.

The most recent publications include a scientific paper by Fox et al. [22], who described naked open market manipulation as a “manipulative trading practice characterized by the purchase of

a significant number of shares in order to artificially drive up prices” and recognized that “naked open market manipulation is an illegal practice, as it distorts market prices and undermines the fairness and integrity of the financial system” [22, p. 74].

Carol & Cumming [23] concluded that it can be difficult from a regulatory and legal perspective to distinguish between ethical trade practices and unlawful fraud and manipulation. In order to decide if trading activity crosses the line into fraudulent manipulation, regulatory authorities must carefully evaluate the existence of consistent and repeating patterns together with other pertinent factors. Differentiating between legitimate trading methods and manipulative acts necessitates a careful analysis and consideration of numerous aspects.

Khodabandehlou & Golpayegani [24] have conducted a systematic assessment of the research on detecting market manipulation from 2010 to 2020, and the 52 most important studies were examined, reviewed, and thoroughly analyzed. The definitions and taxonomies of trade-based manipulation, the objectives, the problem investigated, the methodology, the strengths and weaknesses, the suggested solutions, the data mining approaches, categories, and techniques, as well as the various types of manipulations and anomalies investigated, as well as the suggested future research, have all been reviewed in the selected studies.

In addition, various aspects related to overvalued shares have been studied in different periods by such scholars as Kao et al. [25], Jiang et al. [26], Lev & Wu [27] and Dong et al. [28].

The last block of publications relevant to the topic of our study are publications on stock pledging and abnormal returns.

Gui et al. [29] postulate that “individual shareholders’ stock-pledge announcements often release a signal for financing, thus causing abnormal stock-price fluctuations.” They also demonstrate that before the commitment date, abnormal returns on stock prices collapse. But following the vow,

the stock price almost never experiences negative anomalous returns.

The study of Shi et al. [30] concludes that share pledges by controlling shareholders reduce the usefulness of earnings. When share pledging significantly alters the incentives of controlling shareholders and when it signals a firm’s poor future performance more strongly, the negative effects are more pronounced.

According to the study of Deshui et al. [31], controlling shareholders get more enthusiastic about pledging shares and their scope increases when the share price is overvalued. Further investigation revealed that as the level of share price overvaluation rises, controlling shareholders’ enthusiasm and the size of their share promise both dramatically increase.

Zhou et al. [32] have discovered that pledged enterprises exhibit much higher future stock price crash risk than their non-pledged counterparts during the controlling shareholder share-pledging period. Additionally, compared to the benchmark periods for shareholders’ own pre- and post-pledging, the risk is larger during this time.

In this review of empirical studies, no theoretical studies have described in detail the mechanism of boosting a company’s share price due to capital round-tripping to OFCs and back in the form of FDI.

Moreover, no empirical studies estimate the possible gain (“clean cashback”) for a company from the inflated stock prices resulting from the use of security-based loans backed by those stocks. In addition, no publication includes the calculation of suspected profitability for commercial banks, which arises from the process of capital round-tripping and the inevitable liquidation of the borrower’s portfolio, which will be initiated by the lending bank in the event of a market downshift.

3. Methods

The operation of “capital round-tripping to offshore financial centers and back in the form of FDI as an illegal

way to boost a company’s share price to deposit them as securities-backed lines of credit” mainly consists of two different interconnected processes.

First, an increase in the price of a stock is necessary; this is commonly known as capital round-tripping and is mostly done with offshore financial centers (to obtain as much privacy as possible). The beneficiary holds an “N-amount” of issued stocks of “Company-XYZ” (that are gaining more and more value due to CRT).

Secondly, to cash out the inflated obligations by using securities-backed lines of credit.

Methodology for calculating the beneficiary’s and the bank’s potential gains.

The first step is to calculate the indicators, which reflect the potential gain for the beneficiary. The first calculated indicator is the “Value of initial investment after circular trading”:

$$CTV_i = I_i \times \%RI, \quad (1)$$

where I_i – an initial investment, $\%RI$ – a rate of increase.

The next calculated indicator is “Clean cashback value”:

$$CCBV = CTV_i \times \%CL, \quad (2)$$

where $\%CL$ – a rate of credit line.

Next, we calculate the “return on investment” for the beneficiary using the formula:

$$ROI = \frac{CCBV}{I_i} \times 100. \quad (3)$$

The next couple of indicators reflects the potential gain for the bank. The first is “bank profit through loan liquidation”:

$$BPTLL = \frac{(CTV_i \times (1 - \%CL)) - (CTV_i \times \%IM)}{(CTV_i \times \%IM)} \times 100 \quad (4)$$

where $\%IM$ – an instant margin call rate.

The last step is to calculate the “bank profitability rate through loan liquidation” using the following formula:

$$BPTLL = \frac{(CTV_i \times (1 - \%CL)) - (CTV_i \times \%IM)}{(CTV_i \times \%IM)} \times 100 \quad (5)$$

Due to the diversity of this financial transaction, industry-standard rates have been used in this calculation as it is not possible to obtain accurate data due to the complexity and lack of transparency.

4. Results

4.1. How Does Round-Trip Trading Work?

In tax havens, the vast majority of FDI flows do not go into projects based in the country. Instead, they are redirected back to the source country, a process known as “round-tripping”¹.

Round-trip trading, or “round-tripping”, is the unethical activity of repeatedly buying and selling shares of the same securities to deceive spectators into thinking the security is more in demand than it is. Round-tripping can also obstruct technical analysis that uses volume data by faking trade volume².

When compared to day traders’ or regular investors’ legal open and close transactions, this type of churning activity is very different. In the end, every investor makes a full circle when they purchase and then sell securities.

According to The Wall Street Journal (WSJ), round-tripping, often referred to as round-trip deals or Lazy Susans, is a type of barter in which a corporation sells “an unused asset to another company while at the same time agreeing to buy back the same or similar assets at about the same price”³.

¹ Miles, T. (2013). Global investment falters but tax havens prosper, UN finds. Reuters. URL: <https://www.reuters.com/article/us-tax-havens-idINBRE95P12820130626>

² U.S. Securities and Exchange Commission. “SEC v. Andrew S. “Fastow.” (2002). URL: <https://www.sec.gov/litigation/complaints/compl7762.htm>

³ Cohen, L.P., Angwin, J. (2002). Investigators Focus AOL Probe on Alleged ‘Round-Trip’ Deals. Wall Street Journal. URL: <https://www.wsj.com/articles/SB1029704211820792555>

The substance-over-form accounting principle is broken when assets are exchanged in a round-trip transaction because there is no net economic substance produced, yet the transactions may be falsely recorded on the books of the parties involved as a series of profitable sales and beneficial purchases [6]. The businesses seem to be expanding and quite busy, yet the round-tripping industry does not bring in any money but just inflates the stock¹.

As a result of this instance, the recipient is profiting not from the sale but from the liquidation of shares (usually through shell companies).

Consequently, for the liquidation to be profitable, the beneficiary should own many shares in the company. Round-tripping was essential in temporarily increasing the market capitalizations of energy traders such as Enron, CMS Energy, Reliant Energy, Dynegy, and financial services company Wirecard.

In international contexts, round-tripping is a form of arrangement to evade taxes and launder dirty money [33].

4.2. What are SBLOCs?

4.2.1. Explanation of SBLOCs

The determination of the variable and fixed interest rate tiers for an SBLOC account is based on the maximum drawing power of the loan as indicated in the Bancorp’s commitment letter (the commitment amount), the sum of the Wall Street Journal Prime Rate (WSJP), and the applicable margin.

Borrowers can revolve the credit line, giving them the flexibility to repay the line without early prepayment penalties. There is no minimum draw amount, and there is no time limit to make an initial draw on the line. In addition, clients with a variable rate can convert to a 36-month fixed rate at any

¹ McCrum, D., Palma, S. (2019). Executive at Wirecard suspected of using forged contracts. Financial Times. URL: <https://www.ft.com/content/03a5e318-2479-11e9-8ce6-5db4543da632>

time during the life of the loan at no cost.

Your bank decides how much can be borrowed. However, you might be able to access up to 50% of the total value of your investment.

The idea that you can only utilize the stock in your brokerage portfolio as security for SBLOCs is a common one. Bonds, mutual funds, exchange-traded funds (ETFs), or money market funds all contribute to the available loan value, so you can use a variety of products as collateral for a loan.

A dollar-for-dollar loan won’t be given due to the market’s volatility; however, 60% to 70% of the value of the securities portfolio may be used as collateral, according to Teigen², chief investment officer and certified financial planner at Stockton, California-based FinDec.

Equities typically have advance rates between 50 and 65 %, corporate bonds between 65 and 80 %, and US Treasury bonds around 95 %³. However, the rates might vary from provider to provider.

A line of credit secured by securities may be a useful addition to a portfolio of investments due to the following advantages:

1. Fiscally adaptive. Access funds quickly for a variety of purposes, such as satisfying significant financial obligations or seizing opportunities.
2. Cost-effective. There are no startup costs, and you simply pay interest on the cash you use, which is frequently less than other financing choices.
3. Conceivably tax efficient.

² Tiffany Lam-Balfour, Connor Emmert. (2022). Using Stocks as Collateral Loans: Securities-Based Lines of Credit. NerdWallet. URL: <https://www.nerdwallet.com/article/investing/securities-based-line-of-credit>

³ Investor Alert: Securities-Backed Lines of Credit. (2015). U.S. Securities and Exchange Commission. URL: <https://www.sec.gov/oia/investor-alerts-and-bulletins/sbloc#:~:text=It's%20not%20uncommon%20for%20a,paid%2Dfor%2C%20cash%20accounts>

An SBLOC may be set up in a tax-efficient manner, allowing for more efficient growth and asset preservation. The interest paid on borrowed funds used to buy taxable investments can be deducted from your investment expenditures if you itemize your deductions. Included in this are the interest payments on loans taken out to purchase investment property and stock on margin.

4.2.2. The process of SBLOCs

The total lending value of the securities in your account is available for borrowing by the client. The amount that JPM is prepared to loan against an asset is expressed as a lending value, which is a portion of each security’s market value. Without warning, lending values may vary.

Lending value comes in two varieties.

The maximum amount that could be borrowed against your portfolio is known as the initial lending value (ILV). ILV affects how much of your line you can draw from and whether you can release or exchange collateral.

The maintenance lending value (MLV) specifies how much equity you must keep in your portfolio in the absence of a release or replacement of collateral. Therefore, a

market decline may not immediately result in a margin call. Typically, a security’s MLV is greater than its ILV. J.P. Morgan determines MLVs up to regulatory thresholds.

At first glance, this may seem very complex, so there is a very simple explanation in the form of a table on the JPM homepage comparing two clients.

“Client A”, who is not using a line of credit, and “Client B”, who is using a line of credit (Figure 1).

In both cases, a \$10,000,000 portfolio and a \$3,000,000 debt are assumed.

In the first case, Client A sells securities worth \$3,000,000. During the time under review, the remaining \$7,000,000 in the portfolio made \$483,000 in profit.

Client B uses a line of credit to pay the \$3,000,000 in the second column. Over the same time, his \$10,000,000 portfolio earns a return of \$690,000 without any changes. Client B still makes \$631,500 after fees and interest, which is \$148,500 (31%) more than Client A did.

To be fair, this example from the official JPM website is quite accurate, but it is a bit unclear whether the whole 10 million portfolio backs 3 million of credit from 5 million to 7 million because the

	Client A Not using a line of credit	Client B Using a line of credit
Balanced portfolio	\$10,000,000	\$10,000,000
Liquidation amount	\$3,000,000	\$0
Remaining investment	\$7,000,000	\$10,000,000
Total portfolio return	\$483,000	\$690,000
Total loan cost	\$0	(\$58,500)
Net portfolio return	\$483,000	\$631,500
VALUE ADDED BY USING A LINE OF CREDIT		\$148,500

Rather than liquidating investments, a line of credit was used to cover unexpected liquidity needs

Figure 1. Borrowing vs. Liquidating Portfolio Holdings: Which Strategy Should You Consider?

Source: [JPMorgan Chase & Co. \(“JPM”\)](#)

actual lending amount for a portfolio this size should be 5 million to 7 million (50% to 70%).

4.2.3. About SBLOC rates

The maximum drawing power of the loan, as stated in The Bancorp’s Commitment Letter (Commitment Amount), is calculated by adding the WSJP, the applicable margin, and the maximum drawing power of the loan. This determines the variable and fixed interest rate tiers for an SBLOC account.

Depending on the provider, the credit line can be revolved by the borrower, giving them the freedom to repay it without being penalized for early prepayment. There is no time limit or minimum draw quantity for the initial draw on the line. Additionally, clients with variable rates have the free option to switch to a 36-month fixed rate at any time during the loan’s term. Possible fares are shown in Table 2.

Advance rates (maximum percentages) are presented in Table 3.

Table 2. Variable and fixed interest rate tiers for an SBLOC account

Commitment Amount (Maximum Drawing Power), doll	Variable Rate Calculation, %	36-Month Fixed Rate Calculation, %
100 000 – 249 999,99	WSJP – 0,25%	WSJP + 1,00%
250 000 – 499 999,99	WSJP – 0,50%	WSJP + 0,75%
500 000 – 999 999,99	WSJP – 0,75%	WSJP + 0,50%
over 1 000 000	WSJP – 0,75% (If The Bancorp Bank, N.A. (“Bank”) receives supporting paperwork for a superior offer, negotiated pricing may be possible)	WSJP + 0,50% (If The Bancorp Bank, N.A. (“Bank”) receives supporting paperwork for a superior offer, negotiated pricing may be possible)

Source: SEICAA – SBLOC Interest Rate Information. (2023). Banking services provided by: The Bancorp Bank, N.A. Member FDIC

Table 3. Advance rates (maximum percentages) for different categories of collateral

Type of collateral	Advance Rate, %
Equities	50
Mutual Funds & ETFs	50
Muni and Corp bonds	80
Investment Grade Funds & ETFs	80
Treasuries	90
Cash	100

Source: SEICAA – SBLOC Interest Rate Information. (2023). Banking services provided by: The Bancorp Bank, N.A. Member FDIC

Collateral-based borrowing is not for everyone, and financial experts should evaluate a client’s comprehension of the risks involved. Clients should consult with a tax expert for any tax-related issues and an attorney for any legal issues, as the bank does not provide investing, tax, or legal advice.

As of January 2023, publicly traded stocks listed on a major U.S. exchange with a daily price above \$5 per share that account for no more than 40% of the collateral value (concentrated positions) are acceptable assets for collateral-based borrowing¹.

¹ SEICAA – SBLOC Interest Rate Information. (2023). Banking services provided by: The Bancorp

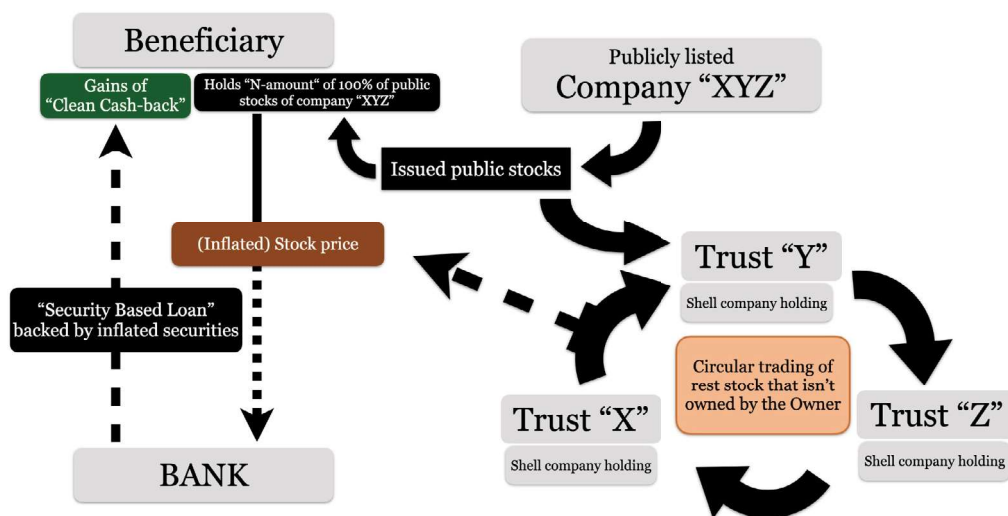


Figure 2. Income generation process

Source: Author's Own

Restricted and controlled shares, assets held in a retirement account, and stocks of The Bancorp Bank, N.A., or an associate are not eligible. The loan products' rates, terms, and conditions are subject to change without notice.

As referenced in Tables 1 and 2, the SBLOC is a non-purpose loan that allows borrowers to choose between fixed and variable interest rate options. However, banks may apply additional rules.

The variable rate calculation states that changes to the commitment amount may result in a change in the interest rate tier and explains that collateral modifications can also cause reassignment to a different rate tier. Further on, the variable rate calculation outlines that existing variable rate borrowers can convert to the fixed rate option, with the variable rate calculation noting that no fee is applied when converting to a 36-month fixed rate loan.

The 36-month fixed rate calculation explains that when the 36-month term ends, the loan balance will become subject to the variable interest rate unless the borrower chooses

to keep the fixed-rate option. Fixed-rate SBLOC borrowers described in the 36-month fixed rate calculation will be charged a \$500 fee when converting to a variable-rate SBLOC before the end of the 36-month term or when locking in a new fixed rate before the end of the 36-month term.

Advance Rates indicate the maximum percentages of securities allowed in the pledged account, while the indicator Cash states that the advance rate for an all-cash portfolio is 95%.

4.3. "Clean Cashback" and visual representation of the income generation process

If both schemes are combined, the result can best be described as "clean cash back" and might be a very harmful combination for financial markets.

The beneficiary of a "clean cashback" holds, ideally, a substantial stake in the business. Circular trading artificially inflates the other portion of the shares. Shell businesses (trusts) are utilized to mask these transactions. Now the beneficiary utilizes his overvalued securities to get a securities-backed line of credit (as shown in Figure 2).

The beneficiary's gain consists of a tax-free "clean cashback" of the overvalued

Bank, N.A. Member FDIC. URL: https://seicashaccess.mybankingservices.com/Global/IB%20-%20Rates/Rate%20Sheets_37_45_145_100_102_155.pdf

stock. Thus, we can interpret a “clean cashback” as the beneficiary’s gain, which consists of tax-free clean cash out of the overvalued stock.

It might not appear to be very lucrative at first, but even if the bank only offers between 50% and 70% of the stock portfolio’s actual value, the value is inflated, and in the event of a market shift, the portfolio is liquidated and margin-called regardless.

Since the liquidation or margin call was the bank’s idea rather than the beneficiary’s, it is even debatable from a jurisdictional standpoint if this is a pump and dump. Because they were provided as a credit line, those games are entirely tax-free.

4.4. Calculation of the potential gains of the beneficiary and the bank

Input data for the calculations are presented in Table 4. Due to the diversity of this financial transaction, industry-standard rates have been used in this calculation as it is not possible to obtain accurate data due to the complexity and lack of transparency.

Table 4. Initial data based on fictional estimates

Indicator	Value:
Number of issued stocks	500
Number of stocks held by the beneficiary	100 (20% of all issued stocks)
Stock price, doll	10
Initial investment, doll	1 000
Number of stocks in a circular trade	400 (80% of all issued stocks)
Rate of increase after circular trading, %	400
Stock price after circular trading, doll	40
The lowest value of the line of credit, in % of the stock portfolio’s actual value	50

Окончание табл. 4

Indicator	Value:
The highest value of the line of credit, in % of the stock portfolio’s actual value	70
Established value for an instant margin call (by the bank), doll ¹	36 (-10% decrease of initial value)

Source: Author’s own formulation

The obtained data are presented in Table 5.

Table 5. Data obtained

Indicator	Value
<i>CTVi</i> , doll.	4 000
<i>ROI</i> (worst case credit line), %	100
<i>ROI</i> (best case credit line), %	180
Best <i>BPTLL</i> , doll.	1 600
Best <i>BPTLL</i> , %	80
Worst <i>BPTLL</i> , doll.	800
Worst <i>BPRTLL</i> , %	28,6

Source: Author’s own analysis

5. Discussion

The results we obtained, reflecting the existence of the enrichment scheme based on the artificial inflation of the share price in general, are new. However, it is important to draw attention to the findings that numerous scientists have made regarding the capital round-tripping process.

Several studies are devoted to the assessment of all possible effects of round-tripping. For example, Cieřlik & Gurshev [34] consider the impact of this process on investment decisions and conclude that the presence of round-tripping FDI partners leads to a mixture

¹ May be triggered by the selling of stocks held by trust holdings.

of horizontal (proximity to customers and concentration of production to achieve scale economies) and vertical (availability of production factors) motives for domestic investment.

Note that none of the studies present results related to estimates of returns from the described process of round-tripping assets for participants. However, several scholars calculate how much round-tripping inflates FDI. For example, Garcia-Herrero et al. [35] recalculate FDI flows, considering distortions associated with stops in OFCs. Their study results in an estimate of the actual size and distribution of Chinese FDI, as well as flows and stocks, based on weighted averages.

In our study, we do not set out to detect the round-tripping process, focusing directly on the assessment of potential income. However, some authors provide techniques to help identify this artifice.

For example, Makowski's idea [36] is to symmetrically measure both outgoing and incoming investments. He proposes to adjust outgoing investments to the values of incoming investments. The suggested approach introduces a deviation from the Own funds at book value (OFBV) from the books of the enterprise with the direct investment of the direct counterparty. OFBV involves valuing an enterprise at the value appearing in its books following International Accounting Standards.

Many academic economists see this mechanism as a threat to the economic security of individual countries and recommend paying close attention to it.

A study by Kalyanpur & Thrall [37] highlights this trend. They found that once a haven signs a bilateral investment treaty with a partner state, elites from the partner state are less likely to round-trip through the haven. One possible explanation is that signing new bilateral treaties with offshore jurisdictions increases their importance at the national level, and increased government control outweighs the benefits of investment protection for potential buyers. However,

they conclude that elites strategically choose offshore jurisdictions that will give them access to the Energy Charter Treaty (ECT). They postulated that one can see more offshore incorporations in havens that sign up to the ECT, setting the stage for the treaty to become the most popular mechanism for elites to file arbitrations against their de facto home state.

The closest to ours are the results of studies that are in one way, or another related to stock price manipulation. Among them are the results obtained by Titman et al. [38]. They discover, using account-level data, that less skilled investors build positions before suspicious split announcements and sell during the post-split period, while small retail investors purchase shares in companies launching suspicious splits. Additionally, they discover that around the start of dubious splits, insiders sell huge blocks of stock and obtain loans using firm stock as collateral. This result is consistent with ours: the fraudulent scheme works. Our results are different in that we consider stock overpricing to be a consequence of capital round-tripping.

Huang & Cheng [39] analyzed the dynamic relationship between abnormal returns, turnover and volatility during the period of stock manipulation in Taiwan stock markets and assessed the impact of stock manipulation on market depth. It was revealed that during the manipulation phase, pump-and-dump manipulations cause significant short-term price impacts, heightened volatility, high trading volumes, short-term price continuations, and long-term price reversals. As a result, they significantly affect market efficiency. In market stabilization situations, manipulation has no effect on market performance other than the fact that price declines and abnormal returns are much less in the post-manipulation era than they were in the pre-manipulation period. These results are consistent with ours in that this illegal enrichment scheme is used in practice and may have negative consequences for the

stock market. However, in the approach we describe, the initiator of the stock dump is the bank that implements the margin call, not the company itself.

Aggarwal & Wu [40] presented theory and evidence of stock price manipulation in their research. They clearly demonstrated that manipulation increases volatility, liquidity, and returns. Prices rise throughout the manipulation period and fall post-manipulation.

Our results are consistent with those obtained in that the authors have developed a method for calculating both the truthful, informed party's and the manipulator's expected profits. They also use the regression model to calculate the average daily returns over the manipulation period as well as over the pre- and post-manipulation periods. It was determined that average daily returns were 6,11% greater during the manipulation period than for the benchmarks, and this difference is statistically significant. The main difference in our results is that we also consider the yield arising from the pledge of securities for the credit line.

One basic limitation of using the results of our research is their approximate character because the calculations are based not on the real share quotations but on artificially set parameters in order to test the proposed methodology.

The research hypothesis is confirmed: there is the possibility of an income-generating scheme based on the process of depositing securities inflated due to the process of capital round-tripping to OFCs and back in the form of FDI under securities-backed lines of credit.

A visual representation of the process and the calculated values of the profitability and return on investment indicators serve to complement this.

6. Conclusion

Overall, our paper adds to knowledge on round-tripping investment by developing a new vision to help explain how a

company's share price inflates due to round-trip FDI activities and examine the way firms generate illicit income by using these inflated shares as collateral for securities-backed credit lines. We introduced a new term for this illicit income: the beneficiary's clean cashback.

The following results were obtained during our study:

Firstly, we found that the extended earning scheme includes two inextricably linked processes: capital round-tripping and the use of a securities-backed credit line.

Secondly, round-trip investors manipulate observers into believing that the security is in higher demand than it is. This comes at the expense of the imaginary expansion of enterprises, which takes place because of an “exchange” of unused assets among them. “Exchange” means that transactions are made at equivalent prices. And the more shell companies are created, the greater the increase in the share price.

Thirdly, the amount of possible credit baked into securities is from 50% to 70% of the total value of the investment. The basic idea here is that the inevitable fall in the price of the inflated stock will result in a margin call, but not immediately. This is because the maintenance lending value, which determines how much capital you must keep in your portfolio in the absence of issuing or replacing collateral, is always higher than the initial lending value. Moreover, it is possible to set up a securities-based line of credit in a tax-efficient way, enabling more effective asset preservation and growth.

Finally, clean cashback value depends directly on how significantly the share price was overvalued (rate of increase). For example, we found that the final potential beneficiary's cashback could be about 180% of the initial investment, subject to a 4-fold increase in the share price. In this case, the bank is not left out either. Its profitability on this credit transaction in the worst case will be 28.6% (if the amount of the credit line is 70% of the total value of the investment)

and in the best case, 80% (if the amount of the credit line is 50% of the total value of the investment).

Theoretical and practical significance lies in the introduction and definition of the term “Clean Cashback” for scientific research, visualization of the income generation process, and development of a methodology to calculate the profitability for all participants involved.

This study is useful by itself as a building block for other studies relating to the calculation of the potential income of the beneficiary and the bank based on the real financial performance of various companies. But it may have more direct implications for exactly how the process of

obtaining illicit income is organized. Our paper focuses only on the round-tripping issue ending with the application of the security-backed line of credit and leaves the ethical implications and other related conceptual and empirical issues for other studies.

The study’s findings can be utilized by financial specialists in the banking industry to assess potential hazards or by policymakers who can use this information to improve legislation against financial fraud.

One additional avenue for further research could be to calculate the stock market’s reaction to a collapse in bloated stock prices, considering the time lag before the margin call occurs.

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Использование искусственно переоцененных акций в качестве обеспечения по кредитам как способ получения дополнительного дохода – «чистый кешбэк»

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Аннотация. Проблема обогащения на основе искусственного завышения цен на акции приобрела особую актуальность в последнее десятилетие в связи с увеличением количества судебных исков, поданных против различных публичных компаний. Целью данного исследования является детальное изучение процесса получения дохода в результате залога искусственно переоцененных акций и определение возможной доходности от этой операции для всех вовлеченных участников. Гипотеза исследования заключается в возможности существования схемы получения дохода, основанной на процессе депонирования переоцененных ценных бумаг компаний под обеспеченные ценными бумагами кредитные линии, предлагаемые финансовыми учреждениями по всему миру. Процедура исследования заключается в поэтапном изучении двух процессов: кругооборота капитала как основы завышения цен на акции и последующего залога акций для получения кредитной линии, а также в применении формулы Дюпона для расчета доходности инвестиций. Основные результаты исследования показывают, что потенциальный доход бенефициара может составить примерно 180 % от первоначальных инвестиций при условии четырехкратного роста цен на акции. Согласно полученным данным, рентабельность данной кредитной операции для коммерческого банка составляет от 28,6 до 80 %. Теоретическая и практическая значимость заключается во введении и интерпретации термина «Clean Cashback» для научных исследований, визуализации процесса получения дохода и разработке методологии расчета доходности для всех вовлеченных участников. Одним из направлений дальнейших исследований является изучение реакции фондового рынка на обвал завышенных цен на акции с учетом временного лага до наступления маржин-колла.

Ключевые слова: чистый кешбэк; кредитная линия под залог ценных бумаг; круговое движение капитала; доходность инвестиций; прямые иностранные инвестиции; манипулирование рынком; маржин-колл.

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