LOST IN TOKYO- HOW JAPANESE VENTURE OF U.S. FINANCE GURU WENT TERRIBLY WRONG

Armstrong Just Tried to Help Recoup Bad Investments, He Says From a Jail Cell

Charm of `Princeton Notes'
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Martin A. Armstrong saw big opportunities in the Japanese market inthe early 1990s. Company after company was struggling to make up hugelosses on stocks and real estate, and the U.S. financial-markets guru thought he could help. "Each one," he says, "had a different nightmare to hide."

A decade later, Mr. Armstrong has found his own Japanese nightmare, one that has him locked in jail in New York City, where he spends his days in a brown jumpsuit facing charges of securities fraud. How Mr. Armstrong got mixed up in the travails of corporate Japan is a tale of wishful thinking and bad bets. It involves market prognostications based on the coins of ancient Rome, 102 missing gold bars and two people Mr. Armstrong crossed paths with in Japan: a brainy yogurt-company executive with a passion for owls, and a born salesman nicknamed King Setogawa.
In the U.S., Mr. Armstrong is being sued by the Securities and Exchange Commission and the Commodities Futures Trading Commission. U.S. prosecutors contend he bilked about 70 Japanese companies out of hundreds of millions of dollars. They accuse the 50-year-old Mr. Armstrong of running what amounts to a giant Ponzi scheme that stretched from New Jersey to Tokyo.

In Japan, Mr. Armstrong's former partner, Akira Setogawa, and one of their best customers, Naoki Kumagai, are accused by Japanese authorities of making or receiving improper payments and of deceiving regulators with false financial statements. The two Japanese deny these charges, but have pleaded guilty to tax evasion. Mr. Setogawa, 66, says through his lawyer that he never deceived regulators or paid money illegally. Lawyers for Mr. Kumagai, who is 69, declined to comment.
Mr. Armstrong says he is innocent. Much of the money at issue was lost by his Japanese clients in the early 1990s, he says, and he was just trying to earn it back for them. Mr. Armstrong says that from the beginning, he had concerns about getting mixed up in Japan's peculiar world of corporate finance. He was running a financial-market newsletter and forecasting operation in the U.S. and turned down a friend's suggestion of expanding into Japan. But then the friend introduced him to Mr. Setogawa, who had studied in the U.S. and had headed international operations at a top Tokyo securities house. Mr. Setogawa was a rainmaker who knew how to close a deal with a flourish: Standing up, with his fist clenched against his chest, he would sometimes say, "Trust me, you won't lose money on this," says an employee who joined him on client visits.
In the early 1990s, Mr. Setogawa signed on to head the Tokyo branch of a French-owned brokerage house named Cresvale International Ltd. He was warm and personable, but kept a tight grip on everything from trading to compensation and back-office bookkeeping, former employees say. They called him King Setogawa. Mr. Setogawa was in search of a winning financial product for Cresvale. He found it in Mr. Armstrong, a New Jerseyan who spun an aura of market savvy around himself and his companies, Princeton Economics International and Princeton Global Management Ltd. (which aren't connected to the university). Soon Mr. Setogawa was translating and distributing the American's market newsletter in Japan, and then designing investment products for Mr. Armstrong to manage. The pair leaned ever more heavily on each other. When Cresvale's parent, a Paris bank, folded in 1995, Mr. Setogawa persuaded Mr. Armstrong to buy Cresvale based on a business plan Mr. Setogawa scribbled out in pencil. The partnership blossomed, nowhere more visibly than at seminars they held at Tokyo's Imperial Hotel. Mr. Setogawa filled the seats with hundreds of customers and potential clients. Mr. Armstrong wowed them with confident, offbeat analysis, wandering from Japan's factional politics to monetary trends in the Roman Empire as reflected in the number of coins produced.
To some, he seemed a Renaissance man. He wrote books on stamp collecting. He used mathematical theories to explain the financial crisis rocking Asia. Japanese who visited the U.S. saw part of his big collection of artifacts, including marble busts of Greek poets, Egyptian carvings and Byzantine coins.

What few knew was Mr. Armstrong's history with U.S. authorities. In 1987, the Commodities Futures Trading Commission fined him and suspended his trading privileges for a year for improper risk disclosure and misrepresenting his trading returns. He also was kicked out of a stamp-collecting group in 1972 amid accusations that he tried to sell two rare stamps he didn't own. Mr. Armstrong says he was treated unfairly in these cases and did nothing wrong.

It was more than Mr. Armstrong's dazzle that pulled in clients. His investment products had a special appeal for some: They could be used to conceal paper losses after the early-1990s collapse of the country's stock and real-estate markets. Mr. Armstrong called one "the rescue product." Companies traded in a losing portfolio of stocks, bonds and other assets for a "Princeton note," redeemable several years in the future for the portfolio's original, higher value. Mr. Armstrong invested the assets, holding out hopes he could recoup the losses with fat returns. Though not all buyers of the notes were trying to hide losses, companies were able to book the notes at the redemption value, not the lower market value of the assets invested, and this had the effect of tucking losses under the rug.

Japanese authorities would later crack down on various such arrangements, called tobashi, or loss shifting. But at the time, regulators largely ignored them. Messrs. Armstrong and Setogawa say the Princeton notes were "tobashi-like" arrangements, but weren't inappropriate.

Among the buyers of Princeton notes was Naoki Kumagai, a senior executive at a maker of yogurt drinks called Yakult Honsha Co. A former elite official at the Finance Ministry's tax agency, Mr. Kumagai was also something of an outsider, with habits some of his Yakult colleagues found peculiar. His home was filled with jade, glass and wooden owls from 25 countries, which he saw as symbols of wisdom and happiness. He dressed in expensive clothes and had a fancy house, but his socks often didn't match and a shirttail sometimes hung out. He was an inveterate optimist who attributed his recovery from cancer to membership in a spiritual sect. Behind his back, one boss called him "the alien." Still, Mr. Kumagai was admired as one of Yakult's brightest executives, especially in financial matters. In the 1980s, Yakult put him in charge of investing its "surplus funds."

Speculative trading was common at Japanese companies in the go-go economy of the late 1980s. They called it zaitech, or financial technology. By 1989, with financial markets at their bubbly peak, Mr. Kumagai had earned a reputation as a "zaitech god" and racked up hundreds of millions of dollars in trading profits.

But starting on the first trading day of the new decade, it all fell apart. The Nikkei stock index began to sink, and Mr. Kumagai's portfolio soon was worth 17 billion yen less than its 62 billion-yen face value,according to a recent Yakult internal investigation. For most of the 1990s, Mr. Kumagai tried to win back the money. "If you quit now, all you get is a loss," he told the daily Nihon Keizai Shimbun in 1992.

He turned to Messrs. Setogawa and Armstrong for help, buying Princeton notes through Cresvale. Mr. Setogawa sometimes went along with Mr. Kumagai to meetings of his spiritual sect, while Messrs. Armstrong and Kumagai swapped gifts. Mr. Kumagai gave a ceremonial Japanese cup, says Mr. Armstrong, who reciprocated with cufflinks made from ancient Athenian coins with owl designs.

Mr. Kumagai poured $400 million of Yakult assets into Princeton products between 1994 and 1996, according to Yakult, becoming Princeton's biggest client. Mr. Setogawa eventually started paying Mr. Kumagai for purchasing Princeton-Cresvale products. Over the years, Mr. Setogawa paid him more than $5 million, which Mr. Kumagai used to pay down a $7 million home loan and to finance shopping trips by his wife in Hong Kong, Japanese prosecutors allege.

The prosecutors charge Messrs. Kumagai and Setogawa with breach of faith against Yakult for making and accepting payments that should have gone to the company. Messrs. Setogawa and Kumagai say the payments weren't illegal or improper. As for Mr. Armstrong, he denies allegations by Tokyo prosecutors that he later approved the payment scheme.

Mr. Kumagai used Cresvale's products to hide his paper losses, say Japanese prosecutors. Typically, he would hand a losing portfolio over to Mr. Armstrong in exchange for a Princeton note recorded at the purchase price of the underlying assets, according to prosecutors and to Yakult's internal investigation. Mr. Kumagai has denied that he ever misled his bosses or improperly concealed losses.

Even as he bought Princeton notes, Mr. Kumagai continued to play the markets, marshaling an array of equity-index options, interest-rate "swaptions" and foreign-exchange derivatives, according to internal Yakult and Cresvale documents reviewed by The Wall Street Journal. He bought Japanese bond futures and speculated in Hong Kong real estate.

His hopes were crushed in mid-1997. Mr. Kumagai was sitting on big bets that Japanese stocks would rise. But in Tokyo, talk was swirling that banks might fail and the financial system melt down. Messrs. Kumagai and Armstrong set up a call to discuss the outlook. Mr. Armstrong says that in the call, he predicted the market would plunge.
Mr. Kumagai, the former Finance Ministry official, vehemently disagreed and said so, with Mr. Setogawa translating. "No, you don't understand Japan," Mr. Kumagai said, according to Mr. Armstrong. "The government is going to support the market."
But the banks that handled Mr. Kumagai's trading were calling on him to put up more collateral against his falling derivative investments or redeem them at huge losses. To raise money, Japanese prosecutors say, Mr. Kumagai began cashing in tens of millions of dollars of his various Princeton investments.

Japanese stocks did plunge in the fall of 1997, and Yakult decided topull the plug on Mr. Kumagai's trading operation. The losses came to 108 billion yen, or more than $1 billion. On the surface, the debacle didn't seem to slow down Messrs. Armstrong and Setogawa. Over the next 17 months, Princeton took in about $750 million from Japanese investors, U.S. prosecutors say. But the withdrawal of Yakult funds came at the same time as U.S. prosecutors say Mr. Armstrong had begun having his own problems with global financial markets. Even as he continued his Tokyo seminars and claimed to be racking up returns of more than 20% a year for investors, Mr. Armstrong lost at least $368 million of their money between Nov. 3, 1997, and Aug. 31, 1999, the prosecutors say.
During this period, they allege, Mr. Armstrong began shuffling funds between client accounts in New York, repaying some clients with others' money -- while also collecting fees from them that were based on false performance statements. Mr. Armstrong denies any knowledge of money being moved between client accounts and says he never deceived clients about returns or the status of their investments. He also denies improperly charging fees. Customers who didn't cash out their notes early made money, he says.
Mr. Armstrong's relationship with Mr. Setogawa began to sour. A shouting match erupted in Cresvale's Hong Kong office in early 1998, Mr. Armstrong says, after Mr. Setogawa asked him to issue phony documentation that Mr. Kumagai could use to conceal his losses from Yakult. Mr. Armstrong says he refused, and "went through the ceiling" later when he says he learned that Mr. Setogawa had gone ahead and issued the false paperwork. Japanese prosecutors have charged Mr. Setogawa with issuing false account statements to Yakult. Through his lawyers, Mr. Setogawa denies doing so. Finally, the long partnership between Messrs. Armstrong and Setogawa crumbled -- which is where the disputed gold bars come in. In Mr. Armstrong's version of events, Mr. Setogawa had purchased a 50% interest in Cresvale back in 1995. Mr. Armstrong testified in U.S. District Court in New York that he bought back the stake for $1 million paying with 102 gold bars that Mr. Setogawa accepted from him in New Jersey in June 1998. Through his attorneys, Mr. Setogawa gives a different account: He never owned any of Cresvale nor received any gold bars.

Mr. Setogawa did, however, step back from day-to-day operations atCresvale, moving to the post of chairman. Mr. Armstrong planned to spruce up Cresvale with an online-trading system and sell the company to the public. "I wanted to extricate myself," he says. But a change in Japanese regulation dashed his plans. Regulators used to overlook loss-hiding deals, but the near-collapse of Japan's financial system spurred authorities to become stricter watchdogs. For instance, they sprang an inspection on Credit Suisse Corp.'s Tokyo office, which had also worked with Messrs. Setogawa and Kumagai, and reprimanded the firm in part for participating in transactions that government officials now deemed inappropriate. Credit Suisse, while declining to comment on specific clients, says it never did anything that was considered improper or illegal at the time. At 6 p.m. on May 24, investigators from Japan's Financial Supervisory Agency filed into Cresvale's Tokyo offices. They left at 3 a.m. toting 500 boxes of files. Within weeks, Japanese authorities alerted U.S. counterparts of records they considered suspicious. Messrs. Armstrong, Setogawa and Kumagai were indicted. Cresvale Tokyo went in receivership.
And at least 11 Japanese companies were soon suing Princeton. In separate trials now under way in Tokyo, Messrs. Kumagai and Setogawa come to court in handcuffs, a short leash tethering them to guards. Across the globe, Mr. Armstrong sits in his jail cell a few blocks from Wall Street. But not because of the criminal charges against him. In an odd sideshow to his case, he is being held in contempt of court for failing to turn over to a receiver an estimated $10 million in coins, friezes, busts and statues that a judge believes are still under his control.
Among the disputed items: the 102 gold bars that Mr. Armstrong claims he gave to Mr. Setogawa, in hopes of disentangling himself from his problems in Japan.