

Unchecked intermediaries: Price manipulation in an emerging stock market[☆]

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Abstract

How costly is the poor governance of market intermediaries? Using unique trade level data from the stock market in Pakistan, we find that when brokers trade on their own behalf, they earn annual rates of return that are 50–90 percentage points higher than those earned by outside investors. Neither market timing nor liquidity provision by brokers can explain this profitability differential. Instead we find compelling evidence for a specific trade-based “pump and dump” price manipulation scheme: When prices are low, colluding brokers trade amongst themselves to artificially raise prices and attract positive-feedback traders. Once prices have risen, the former exit leaving the latter to suffer the ensuing price fall. Conservative estimates suggest these manipulation rents can account for almost a half of total broker earnings. These large rents may explain why market reforms are hard to

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implement and emerging equity markets often remain marginal with few outsiders investing and little capital raised.

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1. Introduction

The governance of equity market intermediaries through the appropriate design and enforcement of law and regulation particularly in emerging markets has received increased emphasis recently (see Glaeser et al., 2001; La Porta et al., 2003). A belief is growing that emerging markets need improvements in their legal and institutional environment to develop. For example, Glaeser, Johnson, and Shleifer argue that self-regulation by brokers in emerging economies with costly law enforcement is unlikely to be successful. However, despite such concerns, little is known about the costs of misgovernance among market intermediaries. Poor regulation and weak enforcement of law lead to what kind of undesirable outcomes? What behavior of market intermediaries should regulation curb? What are the costs when legal and regulatory checks fail? This paper answers these questions by an in-depth analysis of broker behavior in an emerging stock market.

We identify brokers in the stock market who manipulate prices to their own advantage and at the expense of the outside investor. These brokers engage in frequent and strange trading patterns indicative of the anecdotally familiar “pump and dump” manipulation schemes. We show that these schemes result in substantial gains of 50 to 90 percentage points higher annual returns than the average outside investor. These large rents not only explain why many potential rational investors choose to stay out of the equity market, but also from a political economy perspective help provide an understanding of why entrenched players so often actively resist efforts to institute reforms. If such manipulation and its magnitude are substantial, then the results of this paper would add to an understanding of why equity markets fail to develop in many poor economies.¹

The manipulation activity identified in this paper is likely to be prevalent among other emerging markets. Numerous accounts of emerging markets today show similar concerns. Khanna and Sunder (1999), in a case study of the Indian stock market, states that “brokers were also often accused of collaborating with company owners to rig share-prices in pump-and-dump schemes”. Zhou and Mei (2003) argue

¹In the United States, an estimated 50 million individuals, or about one-fifth of the population invest in the stock market directly or indirectly through mutual funds. Over 20% of financial wealth of the average U.S. household is held in equity and equity-linked instruments. In contrast, in an emerging market such as India, there are believed to be no more than 3 million to 4 million retail investors out of a population of more than 1 billion. The Reserve Bank of India estimates that less than 2% of the financial wealth of Indian households is held in equity and equity-linked instruments comprised.

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