



## Trade-based manipulation: Beyond the prosecuted cases

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### ABSTRACT

Using insights from prosecuted cases, we present compelling evidence of large-trade based manipulation in a sizeable number of Indian IPOs that, in all likelihood escaped enforcement actions. Consistent with the pump-and-dump scheme these IPOs exhibit abnormally high volume of large trades, a significant fraction of which originates from a *syndicate* of traders present in the prosecuted IPOs. More importantly, stock price in the manipulated IPOs rises initially on account of artificial trades, but then declines significantly as the manipulators exit the market. Interestingly, not all attempts at manipulation are entirely successful as stock price in some of the manipulated IPOs crash on the first day of listing.

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## 1. Introduction

The costs of market misconduct in a stock market go beyond just the mis-pricing of specific stocks. It deters investor confidence, trust, and participation. In this paper, we examine manipulation in initial public offerings (IPOs) in the context of the Indian market which had a profound impact on overall IPO activity and investor confidence. In light of the revelation, the regulator had to bring in several measures to prop up the confidence in the primary market.<sup>1</sup> Although IPOs are an extremely important source of finance, a high degree of information asymmetry at the time of the offering as well as the complexity of the process makes them susceptible to abuse and irregularities.<sup>2</sup>

In late 2011 the Securities and Exchange Board of India (SEBI, hereafter) brought cases against 7 IPO firms and banned these companies and their directors from accessing the capital market. The investigation uncovered several irregularities including concealment of material information in the offer document and manipulative trades to create artificial demand during the offer and post-listing periods. The irony, however, is that the Indian IPO market is, possibly, one of the most transparent in the world with

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<sup>1</sup> The measures included the introduction of safety net for retail investors and requiring investment banks to disclose their track records. The safety net allows investors to sell their shares back to the issuers if the share price falls sharply during the first six months of listing.

<sup>2</sup> See Ritter (2011) for a review of irregularities in the context of IPOs.

information on investors' bids publicly available on a real time basis when the offer is open for subscription.<sup>3</sup> Further, in response to past irregularities, underwriters in Indian IPOs have a limited role with auction as the main selling mechanism, where manipulation and abuse should be considerably lower (Jagannathan et al. 2015).

Thus, given the setting of the Indian IPO market and the revelation from SEBI's investigation, we begin by conducting an in-depth analysis of the 7 SEBI-investigated IPOs (hereafter, 'investigated IPOs'). Consistent with the idea that it is difficult to move or manipulate a large-capitalization stock (Aggarwal and Wu 2006), we find that the investigated firms are smaller in size, managed by lower ranked underwriters and fail to attract institutional investors. More importantly, in line with the evidence in studies on trade-based manipulation (Allen and Gale 1992; Jiang et al. 2005), the investigated IPOs exhibit abnormally high trading volume, particularly large-volume trades.<sup>4</sup> In conjunction with high trading volume, the investigated IPOs exhibit extreme stock price volatility in the immediate period after its listing.

Given the richness of our data and the fact that trade-based manipulation, by definition, proceeds through large trades (Jiang et al. 2005), we further examine these trades with a particular emphasis on the traders involved. Consistent with the idea that manipulation schemes are undertaken jointly by several parties (Aggarwal and Wu 2006), we find a core set of traders (henceforth *syndicate*) that execute large trades on the first trading day in each of the investigated IPOs.<sup>5</sup> Unsurprisingly, a significant fraction of the large trades in the investigated IPOs originates from this *syndicate*. SEBI's investigation also presents evidence of a nexus between the issuing firms and manipulators with IPO proceeds routed to traders who incur losses in post-listing trades.

In the main empirical section of the paper we use a two-stage strategy to examine the pervasiveness of manipulation in a sample of 228 IPOs issued during the 2006–2011 period. Using the presence of *syndicate* as an instrument, we identify a further 32 IPOs (henceforth, manipulated) that we consider as manipulated. We then test three hypotheses on post-listing trading, large-volume traders and stock returns to establish that these IPOs are indeed manipulated. Not surprisingly, manipulated IPOs exhibit characteristics consistent with investigated IPOs: smaller size, weak institutional interest and managed by a lower ranked underwriter. The more striking results are related to trading and stock price performance. Manipulated IPOs have as much as five times the amount of large trades as in the sample of non-manipulated IPOs on the first day of listing. Further, just as in the investigated IPOs, almost fifty percent of these large trades originates from the *syndicate*.

Consistent with the operation of trade-based manipulation, and more specifically, the pump-and-dump scheme (Khawaja and Mian 2005), stock price in these manipulated IPOs, rises initially, but then falls suddenly and significantly after the first week of listing. The median first day return of 21% for manipulated IPOs tumbles to –35% (a drop of 56%) at the end of the first month listing; the corresponding fall in the sample of non-manipulated IPOs is a modest 2%. This rise and fall in stock price coincides, respectively, with the unusually large trading volume and the manipulators exiting the market. Stock price continues to fall in manipulated IPOs – the median return at the end of the three months is –47%, compared to –7% for IPOs in the non-manipulated group.

An interesting revelation from our analysis is that not all attempts at manipulation appear to be entirely successful. Stock price in five of the seven investigated IPOs and a few manipulated IPOs fall sharply on the first day of listing despite very high trading volume. Consistent with the operation of a manipulation scheme, while large trades dries up immediately in IPOs whose stock price fall on the first of listing, we find significant volume of large trades beyond the listing date for manipulated IPOs that have positive listing return.<sup>6</sup>

Our paper makes two main contributions to the sparse literature on stock price manipulation, particularly in the context of emerging markets where legal and institutional environments are weak. Khawaja and Mian (2005) identify brokers who manipulate prices through pump-and-dump schemes resulting in gains of 50–90% point higher annual returns than outside investors in the Pakistani market. In a similar vein, Khanna and Sunder (1999) document that brokers collaborate with company owners to manipulate prices in pump and dump schemes in the Indian stock market and Zhou and Mei (2003) document evidence of manipulation in the Chinese market. We add to this strand of literature by documenting evidence of manipulation in IPOs. More generally, our study contributes to the literature on trade-based manipulation (Aggarwal and Wu 2006; Allen and Gale 1992; Jiang et al. 2005).

Second, an important innovation of our paper is that we document manipulation not only in the firms that faced litigation from the regulator, but also several other firms that, in all likelihood, escaped regulatory action. Our evidence shows that the prosecuted firms only account for a small fraction of the firms that were manipulated. While most previous studies rely on litigation cases brought by the regulator to examine manipulation (Aggarwal et al. 2005; Aggarwal and Wu 2006), the unique setting of the Indian market as well as the richness of our data allowed us to explore manipulation over a much larger sample. Given that we examine pervasiveness of manipulation, we also document that not all attempts at manipulation are successful with stock price slumping on the first day of trading despite significant trading volume.

The remainder of the paper is organized as follows. Section 2 describes the investigated IPOs. Section 3 reviews the literature and develops the testable hypotheses. Section 4 presents the data, proxy for manipulation and summary statistics. Section 5 presents the empirical analysis of the prevalence of manipulation in Indian IPOs. In Section 6 we perform some additional robustness tests and we conclude with Section 7.

<sup>3</sup> See Neupane and Poshakwale (2012) and Neupane et al. (2014) for a discussion of the institutional settings of the Indian IPO market.

<sup>4</sup> In order to increase transparency and provide information to the market, SEBI requires firms to publicly disclose transactions that account for >0.5% of the number of outstanding shares listed on the exchange. These large transactions are referred to as bulk trades.

<sup>5</sup> The names of a number of these traders appear in SEBI's investigation. A list containing the names of these investors is presented in Appendix B.

<sup>6</sup> SEBI's investigation reveals that substantial sums of money was transferred from IPO proceeds to traders who incurred losses on first day trades. We discuss these in detail in Section 2.

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