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Does it help firms to secretly pay for stock promoters?

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ABSTRACT

We examine deals between listed firms and promoters who have been secretly hired to increase their stock prices. This behavior by the secret promoter is illegal (and leads to prosecution) but the actions of the hiring firm are legal. We use data from these prosecutions to analyze the behavior and motivations of the hiring firms. We find that secret promotion leads to an initial increase in the price and trading volume of the firms on the date that the secret promotion started. Subsequently, however, we find that this increase in price is reversed when regulators (e.g. SEC or NASD) take action against these promoters for not disclosing their relationships with the hiring firms. We find that the main motives behind these relationships are to maximize the private benefits of the firm's managers and owners through pumping the share prices and subsequently dumping their shareholdings.

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1. Introduction

This paper examines secret deals between publically listed firms and promoters, hired by these firms. We examine cases where the promoter offers his/her expertise to raise the firm's share price in exchange for some form of payment (e.g. a fee or a percentage of an increase in the share price). For example, on August 12, 2002, the Securities and Exchange Commission (SEC) filed a complaint against Mark Schultz for promoting at least twelve share issues between 1995 and 1998. (These included Acacia Research Corp., American Entertainment Group and American Nortel Communications among others.)[1] The SEC alleged that Mr. Schultz had made inflated financial projections and predicted share price increases of 100% or more. According to the complaint, he portrayed his analysis as independent whereas in reality he was being paid by the firms for his projections.

In another case (August 12, 2002) the SEC charged the publishers of an Internet newsletter, called the Future SuperStock (FSS), for promoting stocks without disclosing the financial compensation that they had received from the firms they had promoted. The complaint alleged that FSS projected that their recommended stocks would double or triple in price during next three to twelve months. During the period of 1995–2006, 40 such complaints were lodged by the SEC and the National Association of Securities Dealers (NASD) for failure to disclose these relationships and the compensation they received.[2] The legal response from the SEC to these events is that the promoters were charged under Section 17 (B) of the Securities Act of 1934 which states that it is unlawful for any person: "*to publish. . or circulate any notice, circular, advertisement. . or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer. . without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.*"

A key implication of this Act, and one of the central motivations for this paper, is that the hiring firm is not legally liable for hiring such promoters. Only the promoter is legally responsible for divulging the relationship. Indeed, in none of the cases we examine below did the authorities act against the hiring firm, but in all of these cases the authorities acted against the secretly hired promoters.

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[1] These included Acacia Research Corp., American Entertainment Group, American Nortel Communications, AWG, Ltd., Eutro Group Holdings, Inc., EVRO Corp., Imagica Entertainment, Inc., Imaging Diagnostic Systems, Inc., N.U. Pizza Holding Corp., Tessa Complete Health Care, Inc., Wasatch International Corp., and West-America Corp).

[2] However, promoters have continued to engage in this illegal activity beyond 2006. We have found several new cases of this illegal activity in litigation release section of Securities and Exchange Commission.

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An important motivation for our study are recommendations from the "Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission" (April 23, 2006).[3] This report argues that smaller companies are often covered by very few or even no independent analysts. This results in significant lack of information about these firms, which can lead to lower market capitalization and higher financing costs for these smaller firms. Because of this, the report recommended the continuation of the SEC's regulations that allow smaller firms to hire analysts to cover them. Critically, however, these regulations require full disclosure about the nature of the relationship. Kirk (2011) and Billings et al. (2014) look at the value of this 'paid-for research' to the investors and the firm. Our study is the first to examine the case where the hired firm fails to disclose its relationship with the hiring firm. Thus, while Billings et al. (2014) comment that some analyst firms have been investigated by the Securities and Exchange Commission for not disclosing their relationship with hiring firm, our study provides actual empirical evidence on this issue. Specifically, we provide evidence on the type of firms that might hire analysts secretly, and also the motivations behind this surreptitious hiring.

In this paper we use the event study methodology to examine events in which firms hire promoters to increase investor interest in securities without disclosing their association with these firms. We define this event as occurring at the date when the secretly hired promoter begins public promotion of a stock, as defined in the SEC complaints. In all cases in our study, however, the SEC and NASD *subsequently* took legal action against the promoters for their failure to disclose these relationships. These events thus enable us to examine situations where the market is: (1) initially unaware and then (2) subsequently becomes aware of the secret relationship between a firm and a paid promoter.

Specifically, in this paper we examine the following questions: (i) how does the market initially react to recommendations by promoters? (ii) how does the market subsequently react to SEC charges with respect to these promoters? (iii) how do (and if so, which) managers of the firm benefit from such deals? (iv) how much does the promoting company benefit from the deal? (v) whether managers succeed in achieving specific corporate objectives, for example acquiring a firm or raising capital? and (vi) what type of firm is more likely to consider such deals with a promoter?

This paper complements the existing literature, which examines why public firms may choose to misreport, and also to invest in creating opportunities for misreporting. For example, Beneish and Vargus (2002) show the possibility of insider trading increasing after accrual mispricing. Bebchuk and Bar-Gill (2002) examine events of misreporting in order to improve the terms upon which the company would be able to issue equity to finance new projects or stock acquisitions. Efendi et al. (2007) find that the likelihood of a misstated financial statement increases when the CEO has significant holdings of in-the-money stock options.

We find that when the secretly hired promoter begins public promotion (as of the date defined by the SEC complaints) the price of the firm's stock increases for a short period of time. In other words, secretly hiring a promoter can have a positive short-run impact on a firm's share price. The mean Cumulative Average Abnormal Returns (CAAR) is +11.94% for a 5 day period, including the starting date of the promotion and the four days that follow. However, we also find that when a regulator subsequently announces that a financial relationship does (or did) exist between the firm and the promoter, the returns for the firm become significantly negative with a mean CAAR for the same five day window of −32.94%.

A key contribution of our paper is to test various hypotheses as to why we observe such results. The current theoretical literature analyzes the benefits from hiring a promoter to insider and outsider investors. In general, there are two theories. On the one hand, it has been argued that inside and outside investors benefit equally from the promotion since promoters can boost the share price when key assumptions for strict market efficiency fail to hold. For example, Verrecchia's (1983, [Verrecchia, 1990]1990) main focus is on how the disclosure could correct firm undervaluation by costly selective disclosure. The main argument of Merton (1987) and Trueman (1996) is that the source of any undervaluation is mainly driven by investors' unfamiliarity with the firm. Similarly, Diamond and Verrecchia (1991) argue that disclosure helps reduce information asymmetry. Danielsson et al. (2005) contend that different fraudulent activities can take place in hedge funds. These activities include misappropriation of assets, insider trading and lack of disclosure. We document that lack of disclosure can lead to pump and dump behavior and mispricing in publicly traded firms.

On the other hand, Hong and Huang (2005) analyze the private motivation of managers to increase a firm's market liquidity and its stock price arguing that managers of small and newer firms commonly hold large blocks of shares in their own firm, which they might wish to diversify by cashing out. In so doing they use promoter firms to increase the price and trading volume of their shares. The cost of the promoter is thus paid by all investors, while the benefits mostly accrue to managers rather than to dispersed small investors.

In light of these competing theories and to investigate further the questions posited above, we develop two main hypotheses: (i) the "*pump and dump*" hypothesis and (ii) "*shareholders interest*" hypothesis. The pump and dump hypothesis predicts that firms hire promoters to increase the firm's share price and its market liquidity prior to insiders engaging in selling transactions. Thus, the pump and dump hypothesis is consistent with Hong and Huang's (2005) theory of the divergence in the interests of inside and outside investors when hiring a promoter.

On the other hand, the shareholders interest hypothesis predicts that firms hire promoters to benefit from reduced information asymmetry and increased visibility so as to help them achieve corporate objectives, such as raising capital and/or undertaking acquisitions. The shareholders interest hypothesis is therefore consistent with theories that support the view that hiring a promoter increases the firm's visibility and removes information asymmetries which potentially benefits both inside and outside investors (see for example Verrecchia (1983, 1990), Merton (1987) and Trueman (1996)).

To test these hypotheses we utilize both univariate and multivariate analysis. We conduct univariate tests to compare the change in relevant variables before and after the hiring event for our sample of SEC firms. Results from our univariate tests indicate that, following the secret hiring of a promoter, in addition to an initial positive price reaction we also find that insider holdings decrease significantly, insider selling of their shares increases significantly, and the firm's stock market liquidity increases. These findings offer support for our pump and dump hypothesis since they indicate that insiders dumped their shares to benefit from an initial increase in the firm's share price and market liquidity.

However, our univariate results also show that the external investor visibility of the firm improves after a secret hiring, as reflected in the increase in institutional holdings and block holdings during the promotion period. We also find that a large percentage of these firms managed to achieve certain corporate objectives around the promotion period, e.g. raise capital or acquire a specific target. Thus, our univariate evidence supports both our main hypotheses.

[3] http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf

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