

When Small Companies Dabble in Disinformation

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Certaines sociétés ont loué les services de sociétés spécialisées dans les relations avec les investisseurs (promoteurs) afin d'augmenter l'intérêt pour leurs actions. Ces promoteurs n'ont pas divulgué leur association avec ces sociétés et ont publié des recommandations positives.

Companies may contract investor-relations' firms (Promoters) to increase investor interest in their securities. These promoters do not disclose their association with the companies and issue positive recommendations. A review of such cases shows that the price of the firm increases for a short period of time. In all of these, the Securities and Exchange Commission (SEC) and National Association of Securities Dealers (NASD) have been taking legal action against the investor-relations' firms, although only a handful of firms have actually been charged under Section 17(B) of the Securities Act 1934.

Event day (the day that these authorities started legal proceedings) returns for the hiring firms are negative and significant. In addition, the firm's characteristics could help to identify the kind of firms that might hire these promoters. Indeed, smaller firms with free cash flow and higher capital expenditure are more likely to resort to such means. The managers of these firms are concerned about agency problems and try to increase disclosure to reduce the severity of this problem.

The advent of Internet has made the generation of information inexpensive and its distribution instan-

taneous. This fact has not been lost on managers: managers of new and small firms spent a lot of time and effort reaching out to the investing public. H. Hong and M. Huang (2005) conjecture that CEOs of these firms might spend as much as 25% of their time on investor relations. Using agencies that specialize in investor relations might reduce the cost of these activities and might enhance their effectiveness.

Internet and the trading volume

According to D. Deller et al. (1999), the use of Internet as a medium to conduct investor relations is more widespread in the United States of America as compared with the United Kingdom or Germany. B. Barber and T. Odean (2001) look at the impact of Internet on investors' trading behaviour specifically with regard to online trading. They argue that although disintermediation of brokerage houses is a boon for investors, the downside is the loss of advice that the investors were getting from them. P. Wysocki (1998) looks at the impact of message board volume on Yahoo! Message Board on price and trading volume of the underlying stocks. He finds that overnight trading volume is able to pre-

L'arrivée d'Internet a rendu la production de l'information bon marché et sa distribution instantanée. Ce fait n'a pas échappé aux dirigeants de sociétés : les gestionnaires de petites et nouvelles sociétés ont passé beaucoup de temps et dépensé beaucoup d'efforts pour toucher les investisseurs.

Nous pouvons ainsi conclure sur la base d'études récentes que la diffusion de l'information par Internet semble avoir une influence sur le volume des échanges et sur le prix des actions.

dict the trading volume and returns on stocks on next day. W. Antweiler and M. Frank (2004) look at the posting volume on Yahoo! and Raging Bull message boards on 45 Dow Jones Industrial Average companies. Their findings pointed out that these messages are good predictors of volatility, and have a statistically significant impact on returns. We can thus conclude from the recent studies that the spread of information via Internet seems to affect the trading volume and price of the stocks.

The 'third party' information provider

The importance of this has not been lost on some unscrupulous operators. According to a news item on British Broadcasting Corporation (BBC) online, some spammers are contacting firms and offering them their services, promising share price increases of up to 250% in a matter of weeks. These firms usually target small investors and small firms.

Although the motives behind hiring investor-relations specialists might vary from firm to firm, there seems to be a general consensus that the effects will be an increase in price and liquidity. The existing studies do not look at the effect of information emanating from a 'third party' employed by the firm on stock price and liquidity. This third party is required to disclose its affiliation with the hiring firm. However, in the data studied below, it failed to do so, and was charged by the Securities and Exchange Commission. In the

sample, the quality of information seems credible and trustworthy at first sight. However, the non-disclosure of a relationship between investor-relations' firms and hiring firms might lead to more severe information asymmetry and less credibility of firm's information in the long run. It is worth determining if these 'third parties' are able to produce the same results that conventional investor-relations firms produce. This has important implications for credibility of source literature.

Significant but somewhat puzzling findings

Using an event study approach is a good way to look at the impact on price of promotion by investor-relations' specialists. A market model with value and equally weighed index is used to look at the impact of 'promotion' on the stock price. Promotion or event date is defined as the date on which the Securities and Exchange Commission said that these promoters started promoting the stocks. In those cases where the Securities and Exchange Commission did not specify an exact date, information was collected from Factiva or searched for on the World Wide Web. The earliest date as the event date was taken into consideration in all cases. The reutilisation of the same firm if the promoter continued promoting the stock over a number of weeks was avoided.

There is evidence of a surge in stock price on the event date. Average Abnormal Returns of 3.05%

Box 1: **Data and methodology**

We collected information about Investor Relations' Specialists (Promoters) charged by Securities and Exchange Commission (SEC) from the Website of SEC (www.sec.gov). Litigation Releases from 1995-2006 were included.

NASD website was used to find identical cases. Besides these resources, FACTIVA served to collect detailed information about these events. In all the cases, we collected the data on which promoters started promoting these stocks as well as the date on which SEC or NASD filed their complaint against the promoters.

Compustat was used to collect accounting data about these firms. DataStream was a source of information on market price and trading volume data about our sample. In all, 169 firms were found that had Datastream codes available. Of these firms, 116 were used for event study around the promotion date. The reduced number of firms is due to the fact that some of these did not have enough data available for the estimation period. Ownership data from Securities and Exchange Commission files provided by EdgarOnline were also reviewed. Some of these promoters

had their own websites and charged subscribers for their 'independent' services. Some had their own TV programs on which they promoted these companies without disclosing their relationship with them. In other cases, spam or discussion forums were used to promote the companies.

The mean market value of the firms during the estimation period is USD 70 Million. 40 firms were listed on OTC, 4 firms on New York Exchange, 74 on Non Nasdaq OTC, 25 on Nasdaq Non National, 4 on Nasdaq and 7 on Amex. 156 firms in different studies are used in this paper. Of these, 125 firms are still active in the securities market, 2 were suspended and 29 have gone out of business.

Logistic regression was used to see if there are some definite specific characteristics that make a firm more likely to use this specific kind of investor-relations specialist. Sample firms were matched to other firms based on four criteria: (i) Four digit SIC code; (ii) Equity Market for the security; (iii) Fiscal year before event and (iv) Age of the firm. There was however no sample match against market value. B. Bushee et al. (2005) argue that market values for pink sheet and OTCBB firms are often unreliable.

Sur la base de l'échantillon, la qualité de l'information semble à première vue crédible et digne de confiance. Cependant, la dissimulation du lien entre les sociétés de relations avec les investisseurs et les sociétés clientes peut entraîner un manque d'objectivité, faisant perdre de sa crédibilité à l'information émise dans ce cadre.

En observant ensuite l'impact d'une action légale par la SEC ou la NASD sur le prix des actions des sociétés qui utilisent de tels procédés, on constate un effet négatif sur la moyenne des rendements anormaux de ces sociétés immédiatement après la mise sous enquête.

on the event date are economically and statistically significant at a 1% level of significance. Cumulative Average Abnormal Returns (CAAR) remain positive and significant for fifteen days.

This finding indicates that investor relations seem to have an effect on the stock price of the contracting firms. However, there is a wide dispersion in the abnormal returns within the sample and that needs to be explained. Precision weighted cumulative abnormal returns remain above 5% for the first twelve days and then drop to 4% by the fifteenth day after the event. Nevertheless, they still remain statistically and economically significant.

Looking next at the impact of legal action by the SEC or NASD on stock prices of contracting firms, there is a statistically significant negative effect on the Average Abnormal Returns of these firms on the days that legal action commenced. This effect becomes more pronounced after two days of announcement. The Cumulative Average Abnormal Returns (CAAR) remain negative and statistically and economically significant two days after the event and they remain significant for up to fifteen days. This might be due to the slow spread of information in the security prices. Another possible reason is the fact that legal authorities took action a considerable time after the event. Markets might have learned about the relationship between promoters and contracting firms during this period.

Looking now at the returns of firms that were being promoted by the same Investor-relations firms, but were not named in Securities and Exchange Commission complaints, it appears that these firms also suffered negative abnormal returns on the dates that the SEC took legal action. Although, these returns were economically significant, they were not statistically significant. The reason could have been the small number of events. Only 21 such firms with usable data were found.

Smaller firms likely to fall into the trap

Subsequently, firms in the sample are being matched with firms from Compustat database on the basis of fiscal year, industry (SIC code) and exchange listed. Using logistic regression is a convenient way to predict what characteristics distinguish the sample firms from the matched firms. Different accounting variables are used such as total assets, Research and Development, Capital expenditure, free cash flow and leverage as some of these characteristics.

Logistic regression analysis indicates that smaller firms are more likely to hire Investor Relations' specialists. These firms are also more likely to have free cash flow. This supports Jensen's Hypothesis about the severity of the agency problem. The severity of the agency problem might have induced these firms to hire IR specialists. These firms are also more likely to have higher capital expenditure. They might hire IR

La littérature existante suggère que le motif qui se cache derrière l'utilisation de promoteurs par les dirigeants de sociétés pourrait être d'augmenter la liquidité de leurs titres.

Les raisons qui poussent à diffuser de l'information (vraie ou fausse) sont susceptibles de varier d'un intervenant du marché à l'autre. Des sociétés rivales peuvent diffuser de l'information erronée sur leurs concurrents pour ternir leur réputation. Les vendeurs à découvert sont tentés de diffuser de l'information négative dans le but de faire baisser la valeur de marché d'un titre.

specialists to explain the investment opportunities they are facing and the increased capital they are investing.

The existing literature suggests that the motive behind the use of promoters by firms' managers might be to increase the liquidity of the firms' securities. This possibility was explored by looking at different measures of the liquidity of the shares of the firms both before and after the event. The daily average trading volume (measured in the number of shares traded) is compared over one year prior to and one year following the event. Paired sample comparison is a means of seeing if promotions increase the number of shares traded on a given day. It appears that there is a significant increase in the trading volume after the event and it lasts for one year.

Looking next at the average number of trading days during one year prior to and one year following the event, there is a significant increase in the number of trading days for these firms after the event. This suggests that there is an increase in the liquidity of the stocks after the event, as suggested by existing literature.

Looking then at the change in ownership of insiders before and after the event, the average insider ownership decreases from 25.93% to 22.30% after the event. The change is statistically significant in paired sample mean comparison at a 5% level of significance. This indicates that increased liquidity might have been the motive behind hiring these

promoters. The managers of the firms might then have been able to decrease their stakes in the firm. This might be an important consideration for the managers of young firms. Diversification might have been an important consideration for these managers. However, the sample size for insider ownership is limited to 33 firms.

Spreading true information with dubious means

The motive behind spreading information (true or false) might vary from one market participant to another. Rival firms might spread false information about competitors to damage their reputation. Short sellers might spread negative information to drive the stock price of a security down. A recent study by L. Frieder and J. Zittrain (2006) finds that spam works and it earns profits for touters. They suggest numerous regulatory actions to stop the exploitation of investors through this medium.

Although studies looking at the impact of information being spread through Internet have enhanced our understanding of this new phenomenon, there has been no attempt to differentiate among those who spread information. Events in which investor relations targeted 'buy-side investors' to promote the companies that had hired them were looked at. The medium used for promotion varied from Internet to television.

L'information diffusée n'était pas nécessairement fautive. Pourtant, ceux dont elle émane se sont gardés de dévoiler leur lien avec la société concernée. Ce fait est important pour que le destinataire puisse juger de la valeur de l'information et pourrait avoir un impact sur la crédibilité des données fournies.

Cependant, quand une information positive ou négative est diffusée par la presse, elle a une influence sur le coût du capital. Celui-ci augmente quand elle est négative et diminue si elle est positive. Cela vient peut-être du fait que l'on accorde plus facilement sa confiance à la presse financière qu'aux analystes.

Certains des problèmes éthiques liés à l'intervention de sociétés spécialisées dans les relations avec les investisseurs ont été abordés.

However, different methods using Internet were the predominant way of spreading the information. The information being spread was not necessarily false. However, those who spread the information failed to disclose their relationship with the firm.

This fact is important for the receiver to judge the credibility of the information and could have an impact on the credibility of the data released. In one of the earliest studies on the credibility of source and information content by C. Hoveland and W. Weiss (1951), the authors find that subjects were more likely to change their opinion when the information appeared to emanate from a highly credible source as compared to a less credible one.

S.P. Kothari and J.E. Short (2003) look at the impact of disclosure by different sources on stock return volatility and the cost of capital of the firms. They find that positive disclosure by the firm's management does not impact either of these variables. However negative disclosure by management leads to increased stock return volatility and cost of capital. They do not find any impact on cost of capital or stock return volatility when the information emanates from analysts. However, when the positive or negative information comes from the press, it does affect the cost of capital. It increases the cost of capital when the information is negative and decreases it when the information is positive. They conjecture that it might be because of the

higher credibility being attributed to financial press as compared to analysts. But in our opinion, the positive returns found in the study are due to the fact that information is apparently coming from a third source rather than from management.

Not always worth the fuss

The events in which investor-relations' firms receiving compensation try to hide their relationship from investors was studied in this paper. Firms hiring these promoters show an initial increase in the price of their stocks. There is, however, a negative reaction resulting in significantly negative returns when the legal authorities charge the promoters.

Now, smaller firms who have more free cash, and who are investing heavily in capital expenditure are more likely to use these promoters. Their decision to hire IR firms might be an attempt to reduce the agency problem associated with having more free cash flow and a higher level of capital expenditure. Another possible motive might be to increase the liquidity of the stocks. There is support for the hypothesis that managers hire these promoters to create a more liquid market for their securities. Thus, average volume increases during the year following the promotion as compared to the average volume preceding it. The average number of trading days also increases following the promotion, in comparison with the average number of trading days prior the promotion.

Le fait que ces sociétés de relations entre investisseurs ont été inculpées et que les sociétés qui les ont employées l'ont rarement été montre la complexité relative à la mise en application des lois. Car ces sociétés ont clairement bénéficié du comportement illégal des sociétés de relations avec les investisseurs.

As a result, there is increased liquidity resulting from higher trading volume in the underlying securities. There are positive abnormal returns around the event date. This might be considered a result of increased trading and incorporation of 'stale' information in the security prices. It might also be due to the fact that investors really believed the promoters. Another important factor is the fact that these promoters targeted only buy-side investors, which might have led to higher stock prices.

Ethical issues concerning the hiring of investor-relations' firms by different firms were raised here. The fact that these investor-relations' firms

were charged, and that the firms that employed them were rarely charged, shows the complexity of enforcement of laws. These firms clearly benefited from the illegal behaviour of the investor-relations' firms. However, the law enforcement agency did not/could not take any action against them. It might have been difficult to prove in court that the hiring firms knew about the activities of the promoters. But one can argue that these firms were agents of the hiring firms and consequently these firms should have known what their agents were doing, and should, in that capacity, have been prosecuted. •

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