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A Free Market Solution To Persistent Stock Fraud, by Manuel P. Asensio

Even the most ardent believers of the Efficient Market Theory will acknowledge the existence of pricing inefficiencies that can cause individual stocks to become momentarily over or under valued. We believe that these "inefficiencies" are found for the most part during times when events related either specifically to an individual stock, industry group or broader economic developments require that market forces change a stock's valuation. This does not happen instantly or precisely but rather gradually and with volatility. This price inefficiency is a natural, necessary market phenomenon. In fact, we believe that this "inefficiency" creates the incentive that compensates investors for making the expenditures and assuming the added risk that go along with acting as the market's "invisible repricing hand". In other words, the market actions of investors who correctly trade a stock based on a firm conviction that the market price is too low or too high will reap the greatest rewards as payment for performing the function that narrows any "inefficiency".

There are occasions other than those described above when a stock can trade for prolonged periods of time at valuations that are far in excess of any economically justifiable level. Some of these stocks are what we call "grossly overvalued". For a stock to be labeled "grossly overvalued" we must be unable to find any remotely possible outcome that can provide an investor with a "non-risk" adjusted return. In other words, even ignoring risk and assuming that the best possible outcome will occur the stock's present price does not allow investors to realize positive return. When we believe an investor's return is indisputably negative we label a stock "grossly overvalued".

Our work with grossly overvalued stocks has found two main causes of overvalued stock. First is a management that is willing to withhold negative information and create a promotion based on false or factually-deficient information. The second is an investment group that knowingly or unknowingly, assists or creates a network that buys a stock or causes stock to be bought based on fraudulent, inaccurate or incomplete information. These networks have privileges such as special access to management, early notice of promotional events and sharing of investor "cold-calling" leads and scripts. These situations are usually found in the micro and small-cap segments of the stock markets. That they exist is not the issue. More important is the question of how they manage to exist in our high tech, information-rich, highly efficient capital markets.

The incentive to create stock market value is at the core of our capitalist system. There is no practical mechanism to eliminate the incentive of inept or dishonest managers and investor groups to illegitimately promote a stock. Capital markets must rely on industry regulators, government, and shareholder class action lawyers to control the effects of fraudulent over promotion. However, we have found that each of these groups is handicapped and that only the short sellers possess the resources and an incentive powerful enough to combat the strong forces of a concentrated stock promotion.

Both industry self-regulatory organizations and government agencies are severely handicapped in identifying and prosecuting illegitimate stock promotions. Among the factors that complicate regulators' oversight responsibilities are issues of free speech, normal stock market price volatility, genuinely opposing opinion controversies, and a lack of specific industry and company knowledge. Also securities industry regulators are often faced with managers who are advised by sophisticated securities law experts that help stock promoters stay just beyond the regulator's reach. These factors combined with necessary restraints imposed by civil rights legislation on government prosecutors, largely dampen the effect of regulatory oversight on stock promoters.

Shareholder class action lawsuits are also inefficient in controlling excessive stock promotions. There are several factors that contribute to this inefficiency. Defendants have no incentive to settle since they have practically unlimited access to the corporate treasury to fund their defense. The litigation is funded and controlled by plaintiff's attorney whose expertise and incentives are different than shareholders. Finally, the structure of modern portfolio management does not normally allow any one shareholder, or group of shareholders, to have a large enough interest to justify their active involvement in shareholder litigation. On the contrary, sophisticated investors have an interest in extracting themselves from these types of situations leaving the market exclusively to retail brokers and investors that are more susceptible to management's fraudulent promotion. All of these factors may explain the limited effect that some highly revealing shareholder lawsuits have on high profile stock frauds.

Short sellers have none of the disadvantages of regulators or plaintiff attorneys. Short sellers possess, or have an incentive and ability to obtain, highly detailed industry and company specific information. There is no substitute for the profit incentive. However, by imposing much-outdated rules our capital markets restrain short selling unnecessarily. Short sellers are obligated to borrow shares and sell them only on up-tick trades. This often creates situations where short sellers are forced to borrow shares directly from the stock promoters and sometimes have to sell their borrowed shares right back to the very same stock promoters. In effect, the short selling borrowing requirement creates a monopoly for the illegitimate stock promotion.

There is a large and clear economic basis supporting the argument in favor of equal rights for short sellers. Stock promoters have no limits on the amount of stock or price they can pay to buy shares. Stock promoters are free to buy stock at higher and higher prices without regard to up-ticks. Short sellers should have the same rights. Short Sellers must be allowed to sell as much stock as they want and at any price as long as they are financially responsible. The short seller borrowing requirement and up-tick rule must be abolished in the interest of better, more efficient markets.