Stock Market Manipulation & the Enron Scandal

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CHAPTER I

INTRODUCTION

1.1 ORGANISATION OF THE DISSERTATION

This report is organized as follows:

Chapter 1 is a general introduction. The main objectives, rationale of the study, scope and limitations are also discussed.

Chapter 2 is the literature review on the history of stock market, workings of stock market and detailed discussion on disparity in price levels caused by stock market manipulation - all this is done with the help of graphs and stock charts.

Chapter 3 is the literature review on the scandal of Enron detailed information on the downfall of the biggest American energy company.

Chapter 4 provides the methodology and major findings of this research on the stock market manipulation and the Enron scandal.

1.2 OBJECTIVES AND ABSTRACT

The purpose of conducting this research is to present a theory and evidence of how the stock market is manipulated (an attempt or series of attempts to influence the price of stocks by buying or selling in order to give the impression that the stocks are widely traded). The aim is also to show how the market is moved to a point of inefficiency with the presence of information seekers and manipulators and give

a draft of how the Enron scandal took place and explore the shocking discoveries or revelations that have been made during the Enron scandal and its relation with stock price exploitation.

1.3 SCOPE

This research is limited to US companies and the stock markets in general all over the world. Furthermore, the study evaluates the effects the manipulation has over the stakeholders and the laws which have been implemented to control this fraud and make the market more transparent.

1.5 LIMITATIONS

The limitations encountered while conducting this research are as follows:

- Lack of up-to-date books on stock market manipulation
- Broken links on some websites.
- Lack of resources in university.
- Some articles which we had to consult demanded payments.
- Libraries did not have sufficient information on stock market manipulation.

CHAPTER II

LITERATURE REVIEW: STOCK MARKET MANIPULATION

This chapter will provide the literature review on stock market manipulation and its effects on the market efficiency, how it has affected different markets over the years and the people who had invested in those companies whose shares were being manipulated. We have also drawn graphs to show the effect of manipulation of shares and how the prices fluctuate because of the speculators.

2.1 STOCK MARKET

2.1.1 HISTORY OF STOCK MARKET

Trade and exchange has been expanded considerably since its existence. The development of the barter system has led to the emergence of money and trading, further paving way for fairs, caravan routes, active international trade, eventually forming a new social class – the traders. This process gave birth to terms such as paper money, investments and stocks. Thus, for the purpose of news and transaction exchange, first exchange assemblies appeared.

The foremost company to issue shares was the Dutch East India Company in 1606. The innovation of joint ownership made a great deal of Europe's economic growth possible. Before the incorporation of

shares in market, an expensive venture such as the building of a merchant ship could be undertaken only by governments or by very wealthy individuals or families.

2.1.2 DEFINITION OF STOCK

Stock is a share in the ownership of a company. It reflects a claim on a company's assets and earnings. Stockowners are reliant to earn profits or lose money as the company they have invested in, earn or lose money. Stockowners have the right to vote on certain decisions relating to the company. However, the real power to change the course of the company lies with those with the most shares of that company.

2.1.3 STOCK MARKET

A stock exchange is simply a market that is designed for the sale and purchase of stock or shares. It is merely a refined marketplace, linking buyers and sellers. The exchange makes purchasing and selling of shares convenient and brief.

2.1.4 STOCK MARKET MANIPULATION

Price/Market manipulation can take place in a number of ways, from measures taken by insiders that influence the stock price (e.g. accounting and earnings manipulation such as in the Enron case --- which will also be the focus of this paper) to the release of false information or rumors on the Internet. Moreover, it is well known that large block trades can influence prices. For instance, a trader can drive the prices up through purchase of a large amount of stock. If the trader is able to sell shares and if the

price does not adjust following the sales, then it is the trader who profits. Of course, it is normally expected that such a strategy would not work. Selling shares will result in lower stock prices, so that, on average, the trader purchases at higher prices and sells at lower prices. This unraveling problem would seem to rule out the possibility of trade based manipulation.

Results for manipulation cases can also provide a basis for thinking about similar issues when it comes to larger cases of (financial) fraud, given that we can think of financial fraud as an attempt to manipulate market prices.

2.1.5 DISPARITY IN PRICE LEVELS CAUSED BY MANIPULATION

In a market where stocks are being manipulated, the manipulator (in our case usually the corporate insiders, brokers) tries to drive the prices up to peak levels. At this time, the manipulators unload their shares causing the stock supply in the market to increase. During the manipulation period, liquidity, returns and volatility are higher for manipulated stocks. Typically, when the manipulator's supply is cleared, the conditions depress the price so that the manipulator sells at a lower price. The empirical implications of this process suggest that when the manipulator sells, the information seekers are in the market, and their demand exceeds the manipulators supply, which enables the manipulator to profit. The value of a share is revealed, and the in the long run (a time when stock prices have adjusted to fundamental values), the price falls to its true value (it is illustrated in our graph at page 13 table 1).

In general, we expect prices to go up in a manipulation. In some cases, manipulators drove up the price which consequently dropped below the premanipulation level before the end of manipulative activities. Manipulation increases liquidity, volatility and returns. We expect the prices and liquidity to be higher when manipulators sell than when they buy. After the manipulation ends, prices fall. Cases of

accounting and earnings manipulation such as Enron also fit within this illustration. To the extent that these were companies closely followed by information seekers, they were more susceptible to manipulation by insiders.

In such a case of financial fraud like the Enron scandal, manipulators often try to create an extremely high price. They trade among accounts owned by essentially the same individual or group (similar to the off-shore entities created by Enron). This is fundamentally done with a purpose to attract the attention of investors or information seekers. In these cases, it is likely that investors believe there is good news about the stock, without realizing that much of the trading activity does not involve any real change in ownership.

CHAPTER III

LITERATURE REVIEW: ENRON SCANDAL

Our paper focuses on manipulation with detailed emphasis on cases of an informed party illegally manipulating stock prices. In illustrating such a case of Enron, an American energy company and one of the world's leading electricity, natural gas, pulp and paper, and communications companies, with claimed revenues of nearly $101 billion in 2000 we can clearly represent the model where the manipulator takes action such as spreading rumors or engaging in wash sales to boost the stock price. The scandal revealed that the firm's reported financial condition was sustained substantially by institutionalized, systematic and creatively planned accounting fraud.

3.1.1 ENRON SCANDAL

In mid 2000, Enron's stock price reached its peak value of $90. At this point Enron executives, who possessed the inside information on the concealed losses, began to sell their stock. At the same time, the general public and Enron's investors were convinced to buy the stock. Executives persuaded the investors that the stock would continue to climb until it reached possibly the $130 to $140 range, while secretly unloading their shares. [1]

As the executives (insiders) sold off their shares, the stock price began to drop. Investors were told to continue buying stock or hold steady if they already owned Enron by stating that the stock price would recover in the near future.

[1] The vast majority of manipulation cases involve attempts to increase the stock price rather than to decrease the stock price, consistent with the idea that short-selling restrictions make it difficult to manipulate the price downward. We also find that "potentially informed parties" such as corporate insiders, brokers, underwriters, large shareholders, and market makers are likely to be manipulators.

Kenneth Lay's (chairman Enron) strategy for responding to Enron's continuing problems was, as he did many times, to issue a statement or make an appearance to calm investors and assure them that Enron was headed in the right direction.

Enron had created offshore entities (units which may be used for planning and avoidance of taxes causing the profitability of a business to rise). This gave ownership and management full liberty of currency movement, and full anonymity that would enable the company to hide its losses. These bodies made Enron look more lucrative than it actually was, and created a dangerous spiral in which each quarter. Corporate officers would have to perform more and more distorted financial deception to create the delusion of billions in profits while the company was in fact losing money. This practice drove up their stock price to new levels, at which point the executives began to work on insider information and trade millions of dollars worth of Enron stock. The executives and insiders at Enron knew about the offshore accounts that were hiding losses for the company; however the investors knew nothing of this.

Meanwhile, Chief Operating Officer Jeffrey Skilling suggested that the company did not require any assets and by pushing the company's aggressive investment strategy, he helped make Enron the biggest wholesaler of gas and energy, with $27 billion traded in a quarter. Under Skilling, Enron adopted mark to market accounting procedures, in which anticipated future profits from any deal were considered as if earned today. Thus, Enron could record gains from what over time might turn out losses, as the company's fiscal health became secondary to manipulating its stock price on Wall Street during the Tech boom.

“Something is rotten with the state of Enron.”

The New York Times, Sept 9, 2001. [2]

The company’s financial statements were prepared in such a manner that huge debts were concealed, thus inflating the company's true value. In order to help them achieve this, the accounting company, Arthur Anderson, shredded documents that indicated the true state of affairs. By mid-November 2001, the Enron scandal was finally revealed as a result of increasing irregularities in its accounting procedures. It also resulted in the dissolution of its accounting firm Arthur Anderson. With the disclosure of the scandal, Enron’s share prices dropped to just pennies. [3]

Securities law historian Joel S. Seligman was quoted in *The Washington Post* saying, "[t]his was the most important corporate scandal of our lifetimes. It was one of the immediate causes of the Sarbanes-Oxley Act, the governance reforms of the New York Stock Exchange and NASD, and the most consequential reorientation of corporate behavior in living memory."

> Even an acquittal would probably not have saved the firm. "The verdict doesn't matter anyway," says Arthur Bowman, editor of Bowman's Accounting Report. "Arthur Andersen is dead. Once the indictment was handed down, clients started jumping faster than they did off the Titanic." A third of the firm's 2,300 clients have jumped ship; the top clients are gone, and parts of the company have been sold off. About 5,000 of the 26,000 U.S. employees remain. [4]

2. Berenson, Alex. "A self-inflicted wound aggravates angst over Enron.(Statistical Data Included)." The New York Times (Sept 9, 2001 pBU1 (N) pBU1 (L) col 1 (15 col): BU1 (L).
3. Manipulation increased volatility, liquidity, and returns. Prices rose throughout the manipulation period and fell following the manipulation. Prices and liquidity are higher when manipulators sell than when they buy.
4. *"Called to Account"* by Cathy Booth Thomas/Dallas – Time Magazine. Tuesday, Jun. 18, 2002.

Chapter IV

METHODOLOGY & FINDINGS

As discussed in chapter 2 and 3 of the literature review, the research has two main objectives. Firstly to find out how the manipulation takes place and why it takes place, secondly to investigate the steps which are undertaken to stop the manipulation and thirdly how the world's biggest company's share dropped from $90 to 50¢.

METHODOLOGY

An extensive amount of literature, including previous research reports, books, and articles in various journals, electronic databases and internet were reviewed in detail.

FINDINGS

This paper explores the theories on the 'Enron Scandal'. Extending on the framework of Allen and Gale (1992), we consider what happens when a manipulator trades in the presence of other traders who seek out information about the stock's true value. Manipulators don't run out of business because of the information seekers who are always n the look for information that is why they get manipulated.
In a market where manipulators are not present the information seekers help to improve the efficiency of the market by bringing the shares to the level indicated by the informed parties. If there are more information seekers in a market there is going to be greater competition for shares which would open the door for the manipulators to enter this aggravates the market efficiency in respect to price transparency.

Markets can operate efficiently if there is a strong role of the government to discourage manipulation and encourage more competition of information. We have found in our research that manipulators are usually corporate brokers, underwriters, large shareholders and market makers they trade in illiquid stock increasing the stock volatility by manipulating the share price.

In order make the market more transparent Securities and exchange commission tries to regulate the market in our research we have found out that this organization main role is to Facilitate the mobilization of funds by bringing buyers and sellers together to facilitate secondary trading, Provide liquidity, Provide price discovery, Provide Transparency, basically to ensure fairness, efficiency, transparency and investor protection.

We would suggest that information seekers should invest their money in an investment product according to his goal and tolerance of risk, higher the gain on investment, higher the risk involved.

A wise investor should invest his/her money after he/she procured adequate information regarding the investment and analyze company's annual reports, accounts and what is happening in the industry / country.

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Table 1