Share tipping

Pump and dump

Penny stocks are being pushed around by spammers. Investors beware

HLV CAPITAL is a company that prides itself on its share-trading expertise. That must have made it particularly galling when the publicly listed company fell victim to a popular trading scam this month that knocked 37% off its share price in a few days. Written with the usual blizzard of capital letters and exclamation marks, spammers issued unsolicited e-mails telling investors to buy HLV Capital's shares “First Thing” on August 8th. “It's going to explode!”, the headline said. What the tipsters didn't say was that anyone left holding the stock days later would feel as if a grenade had gone off in their hands.

For the hapless company, based in a New York office buzzing with professional traders, there was little to do afterwards except field hundreds of e-mails from distressed shareholders. But such spamming was not a one-off. A recent study by Rainer Böhme and Thorsten Holz*, two computer scientists from Germany's Technical University of Dresden and Mannheim University, respectively, shows the practice is widespread and does have an impact, at least in the short run, on share trading and prices.

The study tracks shares in America's S&P 500, the NASDAQ Composite, the Russell Microcap Index and Pink Sheets, particularly thinly traded ones that tend to be promoted by spammers. Between November 2004 and February 2006, the researchers found 391 different shares that were targeted. The 111 with sufficient historical data tended to fluctuate 13% more after the e-mails went out than other shares on the indices. In the short-term, they said prices tended to rise after a spamming campaign. They did not study long-term effects.

Others have, however, including Joshua Cyr, who runs the website spamstocktracker.com. He has performed an experiment by making “virtual” investments in 1,000 shares after he receives a spam tip. If his investment of more than $69,000 had been real, Mr Cyr would have lost more than $46,000 in the past 15 months. Mr Cyr says share prices spike and then drop, sometimes by more than 90%, before companies realise they have been spammed. Sometimes, they have responded by changing their ticker symbols. Penny stocks are considered ideal for spammers because they trade in low volumes, allowing a small amount of investment activity to generate wild swings in value. This gives tipsters the greatest opportunity to make a profit. Generally, they create excitement about a stock that they also invest in, only to sell it after they successfully push up the price. That can set off a wave of selling which eventually depresses the share price.

The Securities and Exchange Commission has issued warnings about the dangers of such fraud. In 2000 it settled a civil fraud suit against 15-year-old Jonathan Lebed, who used the internet to inflate share prices. He was forced to repay his $272,826 in profit. But the negligible cost of sending mass e-mails and the anonymity of spammers make it an easy business to start and a hard one to stop.

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* "The Effect of Stock Spam on Financial Markets" by Rainer Böhme and Thorsten Holz. Workshop on the Economics of Information Security, University of Cambridge, working paper, April 2006.