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# Alternative Investment Markets under Criticism: Reasons to be Worried? Lessons from Gowex

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## ABSTRACT

The recent financial scandal of Gowex in the Spanish Alternative Investment Market (MAB) has reopened the debate about the dangers of lightly regulated markets and their optimal level of regulation. This article argues that Gowex's collapse was not a failure of these markets but a failure of the gatekeepers in charge of overseeing Gowex's activities. Therefore, we propose that regulators should focus on providing mechanisms to encourage gatekeepers to do their work in an effective and credible way. Namely, we propose that regulators should enhance the role and effectiveness of Nominated Advisers, since these players have been created precisely for the purpose of compensating for the lower level of information issued by companies in these markets. Likewise, when it is not currently applicable in an Alternative Investment Market, regulators should also consider the possibility of implementing some—relatively modest—corporate governance policies applied in Main Markets such as the imposition of independent directors. Thus, by mitigating perverse incentives between directors and executive officers, the board of directors would be in a better position to oversee the managers. Finally, we also argue that regulators should improve the reputation and expertise of their own financial authorities, especially in cases of relatively new Alternative Investment Markets such as the Spanish MAB. Otherwise, they will not create a safe environment for investors; the efforts to preserve the Alternative Investment Market might be useless and costly; and the most likely end for this market would be its closure, as was the case with Germany's Neuer Markt after its reputation was severely damaged as a result of various cases of fraud and corporate bankruptcies in the aftermath of the high-tech bubble.

## 1. THE ROLE AND THE RISE OF ALTERNATIVE INVESTMENT MARKETS

In recent years, a new form of lightly regulated stock market has emerged in many jurisdictions. Despite the different names given to these markets, the rationale for these markets—that we will refer to as 'Alternative Investment Markets'—is the same: to reduce the cost of listing so that small, and normally high-growth, firms

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have the chance to raise capital in financial markets without bearing the regulatory costs required by ordinary stock exchanges.

However, this reduction of the cost of listing is not costless. From the company's perspective, a lower level of information may imply an increase in the cost of capital—that is why, in several cases, companies may have incentives to voluntarily disclose information. From the investors' perspective, these lightly regulated markets may imply either an increase in the gathering costs of information or, alternatively, a higher level of risk that might not always be compensated with a higher return on the company's profits, especially in cases of non-qualified investors. Finally, from a macroeconomic perspective, the costs associated with asymmetric information and the overall increase in the cost of capital may also reduce social welfare. Moreover, a lower level of regulation may also increase the risk of potential scandals, and thus the state's exposure to capital flight.

However, the existence of these markets seems to be socially desirable for two main reasons: first, they reduce the cost of listing for small and high-growth companies. Secondly, they promote innovation and allow start-up companies to raise capital. Therefore, Governments should implement several measures to reduce the main downside of these markets: the aforementioned costs associated with asymmetric information.

There are several ways to reduce asymmetric information in Alternative Investment Markets. However, one of the most important devices used in these markets is the imposition of a new gatekeeper: the Nominated Adviser. The main role of this player is to advise and oversee the company's operation and its level of compliance with regulatory requirements. Thus, companies listed on Alternative Investment Markets and their investors may enjoy the benefits of being listed on financial markets, without bearing the potential costs associated with both ordinary capital markets and lightly regulated markets.

The rise of Alternative Investment Markets in recent decades have been favoured for three main reasons: first, the extremely good reputation achieved by London's Alternative Investment Market. Secondly, the increase in the regulatory burden imposed by the US Securities and Exchange Commission (hereafter, SEC), especially, after both the collapse of Enron and the recent financial crisis. Thirdly, as a result the credit freeze generated in the aftermath of the 2008 financial crisis, the Alternative Investment Markets (AIM) have become one of the most feasible ways to raise capital for many small, and normally high-growth, companies. Therefore, since these markets have become very relevant for many companies and economies, it seems important to preserve the stability of Alternative Investment Markets as a way to promote wealth and innovation.

## 2. GOWEX'S FINANCIAL SCANDAL

Among the few firms listed on the relatively new MAB, the brightest star was Gowex, a wifi provider founded by Jenaro García. Gowex listed on the MAB in 2010, selling 18 per cent of the company for 6 million euros and getting an increase of 20 per cent in the stock price on its first day of trading. As a result of its surprisingly fast growth, Gowex also listed on other lightly regulated markets such as the NYSE-Alternext (period). It was also traded over-the-counter (OTC) in the USA.

In spite of the fact that many of its competitors were registering losses, Gowex reported revenues of 182 million euros and a net profit of 28.9 million euros in 2013. Therefore, all was going great for Gowex: it was reporting profits; it became the brightest star in the MAB; and Jenaro García—its founder and CEO—was even considered as a role model among his fellow entrepreneurs. However, everything changed on 1 July 2014. Gotham City Research LLP, a short-selling US investment firm, issued a report in which it alleged accounting fraud by Gowex's managers and argued that the stock price of the corporation was zero. Namely, Gotham's report alleged, among other things, that (i) most of Gowex's revenues and contracts did not exist; (ii) it was at least 'odd' that Gowex's auditor was being paid a fraction of the audit fees that similar companies were paying to their auditors; and (iii) the real value of Gowex's shares was indeed zero.

## 3. REACTIONS IN THE SPANISH MAB AFTER DISCOVERING GOWEX'S FRAUD

The reactions in the Spanish MAB did not take long. It was not a surprise that Gowex's stock price slumped after Gotham released its report. Moreover, although Jenaro García initially tried to challenge Gotham's allegations, he finally admitted to the fraud. Likewise, at the same time that Gowex's CEO was involved in a criminal investigation, the company filed for bankruptcy.

However, from a policy perspective, it is more relevant to focus our analysis on the impact of Gowex's fraud on the Spanish MAB. Many companies listed on the MAB fell between 10 and 20 per cent in midday trading. More importantly, there were several companies listed on the MAB that threatened to leave the market because they thought that, after this financial scandal, many investors would be likely to lose confidence in the recently launched Spanish MAB.

The Spanish Government tried to calm both companies and investors by announcing several measures to be implemented to restore confidence in the MAB. Among other measures, the Government has recently proposed that companies with a market capitalization of over 500 million euros will no longer be able to remain on the MAB. Instead, they will have to be transferred to the Main Market, incentivizing this movement by waiving, for the first two years of quotation, some regulatory provisions generally applied in the Main Market.

As a result of the credit freeze currently existing in Spain, and the need for investing in innovation, it seems that some measures should be implemented to restore confidence in the MAB. However, we are certainly not convinced about the effectiveness of the measures implemented by the Spanish Government. First, automatic transfer to the Main Market after reaching a certain level of market capitalization does not *per se* imply an improvement in the operation of the MAB. Actually, in our view, this measure may transmit to investors the possibility of new failures. Therefore, even though this measure would indeed minimize the impact of future failures on the MAB, it does not seem to create confidence in investors. On the contrary, it may generate the opposite effect: since the Government seems to implicitly assume new failures may occur, investors could lose confidence in the market.

Secondly, the waiver of certain regulatory provisions to those companies recently transferred to the Main Market does not seem to be a proper measure either. On the one hand, it may create uncertainty among investors. And more importantly, it could provide a regulatory advantage over other competitors within the same market.

In our opinion, the Spanish regulator should focus on providing mechanisms to encourage gatekeepers to do their work in an effective and credible way: (i) enhancing the role and effectiveness of Nominated Advisers, since these players were created mainly to compensate for the lower level of information issued by companies; and (ii) improving the level of reputation and expertise of its own financial authorities.

## 4. REASONS TO BE WORRIED IN ALTERNATIVE INVESTMENT MARKETs?

Gowex's collapse has reopened the debate about the dangers of lightly regulated markets and their optimal level of regulation. But was Gowex's failure an informational problem? More importantly, was it due to a failure of lightly regulated markets, or even due to a failure of the Spanish MAB? In our opinion, Gowex's collapse was not mainly due to the design of Alternative Investment Markets nor the design of the Spanish MAB, but to the failure of those people that, in their role of gatekeepers, should have *effectively* overseen Gowex's activities.

First, the company's directors did not properly perform their work. On the one hand, they should have overseen the executive managers. Moreover, as they are responsible for the preparation of the company's financial statements, they also failed in this function, since the financial statements did not show—as they should have—the true and fair view of the corporation. However, it was not difficult to figure out why the board of directors failed in these functions. First, there were no independent directors, since it is not required in the Spanish MAB. So there was not a *de facto* separation between (i) those that run the company; and (ii) those that both prepare the financial statements and oversee the managers' work. Furthermore, it also seems relevant to highlight the fact that the board was formed, among other members, by the CEO, his wife, and other people related to them.

Secondly, Gowex's auditor also failed in its duties. The auditor is supposed to be a qualified and independent player whose main purpose is to verify whether the company's financial statements reflect the fair and true view of the corporation, according to generally accepted accounting principles. Here it did not seem that Gowex's auditor was either diligent or independent in its work. Moreover, the fact that he was part of a small, non-diversified audit firm did not help to mitigate the natural conflict raised between auditors and audited firms. Indeed, since Gowex's auditor was not exposed to a great reputational loss in case of a potential scandal, he was not subject to market forces to constrain misbehaviour.

Thirdly, the Nominated Adviser also played a questionable role in Gowex's collapse. According to the MAB standards, Nominated Advisers are required to go over all information prepared by the company to be issued to the MAB as well as to verify that this information fulfils the content and deadlines provided within the MAB regulatory framework (see *Circular 10/2010* of the MAB). Therefore, regardless of the desirability of this measure, it could be understood that they were required to at least verify—sometimes, as a 'second gatekeeper'—the *reasonability* of the financial statements.

Finally, the Spanish company responsible for overseeing the MAB, *Bolsas y Mercados Españoles*, did not seem to effectively monitor Gowex's activities. Otherwise, it would have seemed reasonable for it to closely follow Gowex's operations, not only because of its corporate governance problems (i.e., lack of independent directors and the existence of an auditor with higher incentives to commit misbehaviour), but also because it seemed at least suspicious that, at the same time Gowex was reporting profits, almost all of its competitors were registering losses.

Therefore, Gowex's collapse does not seem to put into question either the desirability of Alternative Investment Markets or even the level of regulatory burden imposed by the Spanish MAB. By contrast, it seems to stem from a collective failure of Gowex's gatekeepers.

## 5. CONCLUSION

The recent collapse of Gowex, a Spanish wifi provider, has reopened the debate about the dangers of lightly regulated markets and their optimal level of regulation. Also, it provides a meaningful example about the role of short-sellers, and how their particular incentives may sometimes contribute to enhance transparency and detecting frauds in financial markets.

Therefore, in our opinion, Gowex's collapse does not represent a failure of Alternative Investment Markets but a failure of the gatekeepers in charge of overseeing Gowex's activities. Indeed, what this case does show -once again- is the importance of gatekeepers, especially in the context of Alternative Investment Markets. Thus, for the system to work properly, regulators should focus on providing mechanisms to encourage gatekeepers to do their work in an effective and credible way. Namely, we propose that regulators should enhance the role and effectiveness of Nominated Advisers, since these players have been created precisely for the purpose of compensating for the lower level of information issued by companies in these markets. Likewise, when it is not currently applicable in an Alternative Investment Market, we also propose that regulators should consider the possibility of implementing some—relatively modest—corporate governance policies applied in Main Markets, such as the imposition of independent directors. Thus, by mitigating perverse incentives between directors and executive officers, the board of directors would be in a better position to oversee the managers. Finally, we also argue that regulators should improve the reputation and expertise of their own financial authorities, especially in cases of relatively new Alternative Investment Markets such as the Spanish MAB. Otherwise, they will not create a safe environment for investors; the efforts to preserve the Alternative Investment Market might be useless and costly; and the most likely end for this market would be its closure, as was the case with Germany's Neuer Markt after its reputation was severely damaged as a result of various cases of fraud and corporate bankruptcies in the aftermath of the high-tech bubble burst.