Is insider trading ethical?

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Is insider trading ethical? Is insider trading illegal?

Insider Trading phenomena is controversial and is bringing a lot of discussion around itself. Some of the opponents claim that it's both not ethical and legal to use information, which is not putted into public knowledge, while other opponents argue that insider trading increases market efficiency and does not any hurt to anybody. During this paper I will try to bring topic closer to the reader by providing the reasoning of both parties involved in discussion.

What Insider Trading states for? Who is an insider trader?

It is hard to define insider trading due to complexity of the topic, however the most common definition stands for: Insider trading is illegal when transactions like buying or selling stocks, bounds or other securities are based on information that is not available to the general public. In other words, the inside information which is used by inside traders to influence their decisions before publishing this information to public knowledge, thus giving them an edge in making the best deals, whether to buy or to sell. This competitive advantage according to the law is illegal and according to some scholar it unethical.

Insider informer can take any forms. One can be a member of a company and has stock in the company, and finds out that your company is going publicly bankrupt the next day. Or, quite the opposite, if a business was to be buying out a major competitor, knowing that information before it was publicly announced would also be insider information. Paying someone to be an informant from a company is also considered as insider information and again is illegal. Insider traders are usually defined as company's officers, directors and any beneficial owners of more than ten percent of the

company's equity securities. However, American law is not limiting anti – insider trading law only to these people. In the understanding of this law, any person who trades shares based on material non-public information in violation of some duty of trust. This duty may be imputed; for example, in many jurisdictions, in cases of where a corporate insider " tips" a friend about non-public information likely to have an effect on the company's share price, the duty the corporate insider owes the company is now imputed to the friend and the friend violates a duty to the company if he or she trades on the basis of this information.

Insider trading legal aspects.

Insider trading was not always illegal. First regulation in the USA appeared only in 1929 when the USA Congress passed the laws limiting insider-trading acts, and created the Securities and Exchange Commission to enhance market oversight. Since that time much of the development of insider trading law has resulted from court decisions. Nevertheless there is still a legal dilemma about insider trading as for example: the law prohibits these " insiders" from trading on this information until the information is made public. But even then the definition of what is made public may not be what one thinks. Let's assume that a person working for a company on a proposed merger with another company happens to mention it to a friend who works for a newspaper or news broadcaster who then " publishes" the information. Has it then become public such that everyone is now free to trade in the securities? No. There are also strict interpretations on this subject. The information has become public when the company officially publishes the information by filing it officially with the appropriate authorities, meaning the

Ministry of Finance. The other alternative is for the company, itself, to arrange its publication in two public media such as newspapers, TV broadcasts, etc. Even then, individual has to wait until 12 hours after it is made public.

America has been a pioneer in criminalizing insider trading, but nowadays regulations, which prohibit this phenomenon, are present in law legislation in most of the countries all over the word. As example: “ In the UK, ‘ the relevant laws are the Criminal Justice Act 1993 Part V Schedule 1 and the Financial Services and Markets Act 2000, which defines an offence of Market Abuse.“ Just like in American law, it is also illegal to fail to trade based on inside information. The principle is that it is illegal to trade on the basis of market-sensitive information that is not generally known. No relationship to the issuer of the security is required; all that is required is that the guilty party traded (or caused trading) whilst having inside information.’In comparison in Japan first law against insider trading appeared in 1988 but even now as Roderick Seeman claims that: “ many Japanese do not understand why this is illegal. Indeed, previously it was regarded as common sense to make a profit from your knowledge.”

Insider trading – Ethical Dilemma.

Even with existing laws and regulations, ethical dilemmas still exist and the laws are sometimes vague. When we analyze insider-trading phenomena, we can ask ourselves the question what is wrong in taking good luck and opportunity to advance in business and profit? I would answer NOTHING, except the fact that it is an illegal act.

That is why some economists and authorized scholars, like " Henry Manne, Milton Friedman, Thomas Sowell, Daniel Fischel, Frank H. Easterbrook argues that laws, which makes insider trading illegal should be cancelled." They claim that insider trading based on non-public information benefits investors, as well, by more quickly introducing new information into the market and in this way speeds up market efficiency, which is a benefit for all parties. Moreover according to some economist such control over the stock market is too much government regulation in the stock market, and in same way is harmful to capitalism. Henry Mann,' argues that the legislation has not stopped insider trading from happening, and that legalizing it is a sensible solution to the improper regulation that ultimately hurts the market. He also claims that if insider trading is allowed, it will allow stocks to show its actual worth, rather than have the price tempered by waiting for the information to go public.' Another great economist Milton Friedman, laureate of the Nobel Memorial Prize in Economics, said: " You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that." Friedman did not believe that the trader should be required to make his trade known to the public, because the buying or selling pressure itself is information for the market."

This brings me to another critical issue. Does the fact of possessing information bring necessary any value? No, because to act on any piece of information requires interpretation of that information, which in turn requires a large number of other pieces of information. Let's imagine that for example Apple announced that that its Q4 profits have raised by 45 percent. This

doesn't really tell anyone how to perform it in the market for Apple securities, whether to buy or sell. This requires additional general knowledge about IT market, the profits of other IT companies and Apple main competitors future actions plan and so on. Only if we add to the Apple announcement information about Microsoft's profits, which let says, could have raised by 100 percent, we can draw father conclusions. So any single piece of information about a company, however critical it may be to that company and its future, does not in itself provide clear instruction to the investor. Action requires interpretation, which requires wider knowledge.

Many market theorists have argued, that insider trading " enhances market efficiency, smoothes price volatility and reduces the likelihood of price shocks arising from unexpected events." On the other hand, when we think about illegal aspect of these phenomena it is hard to not agree that providing information which are not public to the everyone knowledge introduce the problem of the fairness. Fairness which in these case would hold that " in a fair market, all parties have equal access to information relevant to asset valuation, but entitled to nothing more". So in this situation insider trading is perceived as an unfair act, it causes some injury to specific traders or potential traders, or because it causes investors as a whole to lose confidence in the securities markets. " To illustrate, assume that insiders are aware of negative information regarding Alpha Corporation that, if disclosed, would cause the current per share market price of Alpha stock to drop from $25 per share to $20 per share. Prior to public release of the information, Alpha insiders sell Alpha stock on the basis of this negative information, reducing Alpha's price to $23 per share. Some outsiders will undoubtedly sell

at $23 and could thus legitimately claim to be $2 per share poorer than they would have been absent insider trading. A corresponding number of investors, however, will purchase at the more " correct" price of $23 per share, making them better off than they would have been in the absence of insider trading. Although the $23 per share price is higher than the $20 per share price that would have prevailed if the insiders had been forced to reveal their secret information prior to trading, this harm is attributable to the lack of a general duty to disclose material non-public information under the federal securities laws and not to insider trading.'

This example touches another critical issue in the insider trading discussion like stock price manipulation phenomena. We can imagine the situation where insider traders manipulate investors by releasing fails information about company in order to move market prices away from their fair values and take financial benefit from it.

As the last, insider trading also violates the duty of trust or confidentiality that one individual or business entity owes to another. This causes loss in confidence in the securities markets. People fear that insider traders regularly take benefit at their expense, which lead to decrease people in willingness to invest. In this case raising new capital would be more costly for companies whose securities were harmed by insider trading. Hence, all else being equal, insider trading makes it harder for companies to raise money when opportunities to undertake new projects arise.

Conclusion

For sure there are no clear and easy answers to the question of regulating insider trading. Insider trading may have benefits for both the company and the capital market under certain conditions. As was presented above insider trading can positively influence the market effectivness – Henry Manne – Insider Trading and the Stock Market. However, the arguments against regulation show a certain ambiguity and doubts of regulators are proven. Even though scholars often argue that fairness considerations do not carry much weight, the personal feelings of the individual investor and his confidence in the integrity of securities markets must be taken into account. Although insider trading can have positive effects for the firm and its wealth, as the arguments of deregulators show, it also bears several severe risks. The costs seem to outweigh the benefits. Therefore, it is correct to prohibit insider trading by a mandatory regulation.