Insider trading

Business

Introduction Insider trading is a common term among investors and is usually linked to illegal conduct. Nevertheless, the term includes both legal and illegal conduct.

The legal aspect of insider trading is when corporate insiders, which include directors, employees, officers, and large shareholders, sell and buy stock within their organization. It is mandatory for corporate insiders to report their trades to the Securities and Exchange Commission (SEC) when they trade in their securities (Corwin & Lipson, 2000). This is because many traders and investors use this information to pinpoint organizations with investment capability. The concept behind this is that insiders have more knowledge about their organization than any other person does if they are buying their own company's stock (Corwin & Lipson, 2000). The illegal aspect of insider trading happens when the trade of stock has been affected by the restricted possession of corporate information, which has not yet been publicized. Since such information is not accessible to other investors, the person possessing it gains an unfair advantage over other investors (Corwin & Lipson, 2000).

Consequently, investors planning to join the stock market must know the reasons for the illegality of insider trading. In this regard, the paper discusses why insider trading is illegal. Discussion In 2000, the SEC implemented new statutes concerning insider trading (O'Hara, 2001). SEC rules defined insider trading as transactions of securities conducted when the individual behind the transaction is aware of the nonpublic information, and, therefore, is infringing his obligation to maintain confidentiality of such

information (O'Hara, 2001). SEC also defined information as the material that, if released to the public, could affect the stock price of the company.

Examples of material information considered by SEC include the announcement of receiving a tender by the company, positive earnings, and declaration of mergers, among others (Corwin & Lipson, 2000). The people involved in insider trading break their own fiduciary duty (Corwin & Lipson, 2000). The trade occurs due to information leakage outside of the organizational boundaries. Insider trading involves actions of two partners: tipper and tippee (Munson & Leach, 2000). The tipper is the one who breaks his fiduciary duty by revealing nonpublic information. The tippee is the individual who uses such public information knowingly to make a trade.

The tippee also breaks his confidentiality by using nonpublic information knowingly to make trade. These partners engage in such illegal trade for mutual financial benefit. Tippers can also be anyone who is close to the inside management of the organization. For instance, the spouse of company's CEO can be a tipper if he or she secretly informs the public of inside information concerning the organization. It is very difficult for SEC to justify whether an individual is a tippee.

This is because influence and route of insider information are not traceable. According to Bird & Brusiloff (2000), insider trading involves an individual or a group, which trades shares based on the organization's rivate data. This enables the group or the person to make huge profits at expense of other traders in the stock market. The use of private information for trading infringes transparency, which, according to Corwin & Lipson, (2000), is the

foundation of capital market. In a transparent market, information should be disseminated in a way by which all traders receive it at the same time. In such markets, the trader gains advantage over others only through acquisition of skills that are necessary for analyzing and interpreting the available information.

The skills are based on individual awareness and merit. An investor trading with private information on hand gains the advantage, which is not possible for other investors. According to O'Hara (2001), this is unfair and disruptive to an effectively functioning stock market. Legalizing insider trading would deprive investors of confidence in their knowledge about the organizations of interest. As such, they will no longer invest.

Investors are most likely to pull out their money of the company upon realizing the occurrence of illegal trade. Reeling from the bad news, the company gets into more problems. According to Munson & Leach (2000), insider trading is illegal because it aggravates the problem. Insider trading also has a significant effect on the company, which is also the reason why it is illegal (Machan, 1996). However, most of the above-mentioned problems of insider trading are only a portion of the possible trouble. Usually, it does not take much time for other traders to realize that an illegal trade has been occurring.

Not only does the value of the shares drop because of the quarterly financial report loss, but also the illegal accounts of trading make things worse. It is apparent that the effects of insider trading on stock market make it illegal (Bird & Brusiloff, 2000). These effects can easily result in a domino effect.

Assuming that company X is a bank that has been accused of insider trading; those who purchased shares in other banks will be startled. Even if these investors' banks were not a victim, they (investors) will sell their shares in order to be sure. Other investors are likely to think that other bank shares are falling because of the illegal insider trading.

These investors might as well start dumping their shares (Munson & Leach, 2000). Insider trade has some effects on the economy, which have been perceived as one of the reasons for its illegalization by the government. If a larger organization has been victimized, the effects on the economy can be significant. According to Corwin & Lipson (2000), the stock market acts a barometer of a country's health status. Consequently, once the stock market starts to decline, it can result in panic.

Therefore, investors will pull out their hot money and foreign investments, which, in turn, affects the currency and results in all sorts of economic problems. Insider trading has effects on comprehensive economic variables. Various microeconomic theorists, such as O'Hara (2001), have argued that legalizing insider trading would significantly reduce the liquidity of companies, but enhance the informational effectiveness. In addition, insider trading can considerably raise the cost of a company's capital. For instance, O'Hara (2001) assumes that a ccompany's insiders have nonpublic information concerning forthcoming corporate cash flows.

Allowing insider trading raises the exchange losses incurred by liquidity traders when they sell their securities to fulfill their liquidity needs, thus lowering the liquidity of the company's stock and discouraging trading

activity. Evaluation From the above discussion, it is reasonable to affirm that insider trading is illegal because of its tremendous negative effects on the economy, stock market, and the company (Bird & Brusiloff, 2000). As much as various financial economists take the view that insider trading needs to be legal, its negative effects outweigh the benefits. In fact, it does not seem to have any appreciable impact on the markets, at least as analyzed by the occurring volume of trading. It is extremely difficult to imagine that insider trading has much effect on the market, given that billions of shares are traded on a daily basis.

It is also important to note that insider trading is an unethical practice that promotes unfairness in the stock market (Bird & Brusiloff, 2000). The illegality of this transaction is based on its injustice aspect. The acquisition of nonpublic information by a certain investor gives him or her advantage over other investors. Use of private information for trading infringes transparency, which is the foundation of capital market. RecommendationsThe first recommendation to avoid committing insider trading is to use news. Investors should deploy third-party sources of news to acquire necessary information for making decisions (Corwin & Lipson, 2000).

Investor should have a wide list of contacts including stock traders, journalists, and executives, as he or she gains more experience in stock trading. However, it is important to first turn to news outlets when information concerning certain securities is required. The idea behind this is that reading information concerning securities in a newspaper is not an evidence for committing insider trading. Checking the data is also recommended to ensure that an investor does not land into committing the

offense. Bird & Brusiloff (2000) suggested that investor should validate all information communicated personally against sources of news in order to ensure that the public has access to the information. If the information cannot be found in publicly available sources, it is prudent for the investor not to act on it.

Conclusion The paper discussed the illegality of insider trading. The trade occurs due to leakage of the information outside of the organizational boundaries. People involved in insider trading break their fiduciary duty. Insider trading involves an individual or a group, which trades shares based on the private data of an organization. This enables a group or a person to make huge profits at the expense of other traders in the stock market.

Insider trading has a significant effect on the company, which is also the reason why it is illegal. Insider trade has some effect on the economy, which has been perceived as a one of the reasons why it is illegal.