

Financial markets and institutions assignment



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" Can financial markets ever be considered to be truly efficient; given that insider trading is prohibited in a number of jurisdictions? Further, what might have been the pitfalls and the benefits of relaxing insider trading prohibitions in the context of the recent (and on-going) difficulties and uncertainties in financial markets?" This report has been undertaken to consider whether financial markets can ever be truly efficient, with specific relation towards insider trading and the connotations different proposals on the regulation of this activity could have on the on-going difficulties and uncertainties in the financial markets at present. To explain some of the fundamental terms this report will be discussing; A financial market is any market place that allows traders to buy and sell financial assets such as bonds, shares, commodities, currency's and derivatives. They are typically defined by having transparent pricing, basic regulations on trading, costs and fee's and market forces determining the prices of securities that trade. Examples of financial markets include the New York stock exchange (NYSE) and the forex markets. Insider trading defines the buying and selling of securities by someone who has access to material, non public information about the security. A controversial example of this was the Kenneth Lay Enron scandal in which Mr. Lay used his inside knowledge as a company director to sell his shares in the company just prior to the company filing for bankrupt [1]. At present, there are three main types of market efficiency; Allocative efficiency (production and distribution), Operational efficiency (market micro structure) and informational or pricing efficiency (Efficient market hypothesis). ' A market is said to be perfectly efficient if it is simultaneously allocatively, operationally and informationally efficient'[2]. Types of Market efficiency

Allocative Efficiency -The role of the markets in a competitive economy is to allocate

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the limited resources it has available in the most productive way, this means that the highest bidder for the resources gets to use them. When this happens a market is said to be allocatively efficient. Financial markets duty is to allocate all the investable resources in a way which is allocatively efficient. Operational efficiency -This is a market condition where participants can perform transactions at a price which equates fairly to the actual costs required to provide them. In other words, the market operates in a competitive environment with market-makers and brokers earning normal profits (not abnormal profits) on their activities. In a strict theoretical sense, this implies that the transactions costs of making a market are zero, however in reality this is not the case as markets wouldn't exist if the people who operated them were not rewarded for doing so. Informational efficiency (EMH) - In this situation, current market prices 'instantaneously and in an unbiased manner fully reflect all relevant available information', this being the efficient market hypothesis. Due to it being difficult to conceive how a market could be operationally and allocatively efficient, without being informationally efficient, this has resulted in a situation where market efficiency has loosely or widely been used interchangeable with informational efficiency. However, due to insider trading being prohibited in many jurisdictions, the question still remains whether a market can really be truly efficient as insiders will obviously have better information than the market. EMH also implies that technical and fundamental analysis is useless as no-one can beat the market, this may or may not be true; but in the short term at least, these techniques can have some success. The EMH can be broken down into 3 or possibly 4 main forms: The weak form says that current security prices instantaneously and fully reflect all information

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contained in past history of security prices. In other words, past prices past prices don't provide any useful indication of future prices that could allow an investor to make excess returns from using trading rules based on historical prices. The semi strong form says that current security prices instantaneously and full reflect all publicly known information about the securities markets. If this hypothesis holds true, then when any new information becomes public knowledge, its quickly incorporated into security prices. This version of the EMH implies that there are no learning lags that could give rise to profitable trading rules. The strong form says that current security prices instantaneously and fully reflect all known information about securities markets including privately available inside information. This version of the EMH implies that the markets respond so quickly that not even someone with the most valuable inside information can trade profitably on the basis of it. The random walk theory is also another possible hypothesis in which it is suggested that successive prices are uncorrelated, with prices equally as likely to rise as they are to fall and making it impossible to predict. For example if you consider a drunken person's path of walking to be random because the person is impaired and his walk would not follow any predictable path. This theory corresponds to the belief that markets are efficient and that it's not possible to beat or predict the market as stock prices reflect all readily available information and the occurrence of new information is seemingly random as well [4]. As shown in the graph below.

Insider trading Insider trading as previously stated is banned in many jurisdictions for a number of reasons. It is argued that it is unfair on other investors who do not have the same information, it may destabilise markets by encouraging rumours, may deter investors participating in certain

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markets (undermining the basic purpose of the markets; to raise company's capital) and intrinsically involves profiting from a breach of confidence.

However, there is also an argument that insider trading increases market efficiency by allowing this secret information to influence prices, and therefore improve the efficiency within the markets; some form of leakage is required to bring markets anywhere near the strong form efficiency. The penalties on those individuals/groups found guilty of participating in this act are becoming ever more severe, as shown in the recent hedge fund titan Raj Rajaratnums case, with the prison sentence reaching double figures [3].

Insiders who wish to exploit price sensitive information tend to collaborate with traders to make it harder to trace the trades back to the individual who is known to have access to the information, this is referred to as an inside ring. The fact that insider trading has been criminalised implies that excessive returns could be made from trading on this inside information and as such, the strong form hypothesis can be rejected. Given that insider trading is prohibited, it is difficult to see how a market can ever be truly efficient as prices with this lack of information, wont fully reflect their actual value; this completely highlighted by the Enron case with bribes and bad practice used to propel its share price way above its actual value.[7].

However It doesn't necessarily mean the markets are inefficient either. In truth, there are periods of time when a market is highly efficient, I. e. no-one making abnormal profits, and then there are times when its inefficient I. e. people making abnormal profit/losses. Rather than generalising and asking whether a market is truly efficient or even if that's possible, it is a more sensible and accurate approach to calculate the relative efficiency at a given time as it's something which can be measured relatively easier. For example,

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a particular manager may earn abnormal profits in one period, followed by normal profits or even losses the next period. This would tend to agree with the efficient market hypothesis on a more long term basis as there has been little evidence to support any correlation with a particular investor making consecutive abnormal returns, as over time it is suggested that only normal returns/losses are possible. The problem with answering this question is that it's notoriously difficult to test the efficiency of a market, and in particular the strong form. There are so many contributing factors to markets, whether that be financial information or more qualitative/technical factors, that analysing the degree and extent to which each of these factors affects prices is basically impossible as it varies on an individual basis. On the whole, it is difficult to argue that markets can ever be considered to be truly efficient with insider trading still prohibited in many jurisdictions as insider trading causes equity prices to disclose all relevant information at a much greater rate than would have otherwise been, bringing them back into line with underlying market conditions. It's still perfectly possible for markets to have a degree of efficiency by themselves, But for true efficiency, insider trading really is a necessity. The effects of altering the inside trading law on today's financial difficulties There is little disagreement that insider trading increases market efficiency by moving the current market price closer to the future post disclosure price, this results in more accurately priced stocks which give valuable signals to investors and ensure a more efficient allocation of capital. This being said, The financial difficulties the global economy now finds itself in was primarily caused by the US mortgage market, offering subprime mortgages to customers, then once realising customers would struggle to pay off these mortgages, increased the interest rates to try and re-coupe

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their investments which only resulted in an even greater number of defaulted mortgage repayments. Another blunder came from the inaccurate credit rating of the collateralized debt obligations which the banks created to sell the debt resulting from the defaulting mortgage repayments to other investors. This inaccurate credit rating resulted in investors jumping at the chance to invest in these CDO's with seemingly high reward and low risk involved. However this was obviously not the case as they were dependant on the US repaying their mortgages; which blatantly wasn't going to happen and lead some people to criticise the banks as they must have known that before issuing the CDO's [6]. Once it became apparent to investors (mainly major banks) that the CDO's were not going to be re-paid, banks such as RBS essentially stopped lending to each other resulting in credit becoming much more expensive and harder to get hold of i. e. ' the credit crunch'. In my opinion, relaxing the insider trading laws could have had two possible outcomes on the financial crisis. The first of these is that if insider knowledge was used, then fewer investors would have invested in the CDO's which were ultimately the major contributor to the economic state we now found ourselves in. This is because with use of the extra information, investors would have had a better insight into how the CDO's were constructed meaning that they would be more aware of how they were made up of debt relating to the US mortgage markets and the high probability that the investments wouldn't be returned. This extra inside information would have also been incorporated into the price of the CDO's making their value more accurate. The other alternative that relaxing the insider trading laws could have had is it could have made absolutely no difference what so ever. Investors could have still bought the CDO's due to their inaccurate credit

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ratings showing them as low risk, high reward investments. In conclusion, with this in mind there is a stronger argument that relaxing the insider trading laws could have had a potentially greater benefit to the economy than leaving them as they are (prohibited). The cost benefit analysis of relaxing the laws on insider trading ultimately might show that this could lead to a rise in insiders using this change in the law to their advantage, however by doing so they would be also be moving the market prices a lot closer to their real value's for the millions of other investors in the market (whose numbers greatly outweigh those with the inside information), and therefore making the market more efficient for everyone. Instead of regulating inside trading, perhaps a change of approach to a taxation of the activity is needed, this resulting in the market prices being much more accurate and people with the inside knowledge being taxed on their excess gains so they don't make consistent abnormal returns which would be extremely unfair on other investors [8].