Assessing The Following Types Of Behaviours That Have Occurred/ Occurring In The Financial Markets

INSIDER TRADING

An "insider" is an individual who either has access to valuable information that isn’t available to the public regarding a business entity making them a high-level executive insider. It’s an unfair practice, wherein the other stockholders are at a great disadvantage due to the lack of important insider non-public information. However, in circumstances, if the information has been made public, in a way that all concerned investors have access to it, that will not be a case of illegal insider trading.

VICTIMS OF INSIDE INFORMATION? WHY IS IT DONE?

One of the victims are the people who are part of/ work within the financial markets. A select number of people trade on non-public information, the integrity of the markets that will be damaged and investors will be discouraged from partaking in them as they know they have a vast disadvantage against those who possess such information. Insiders will avoid losses and benefit from the gains, effectively surpassing the inherent risk that investors without the undisclosed information take on by investing in the markets. Eventually, if investors begin to withdraw from the markets due to the lack of information they possess, there would be no other investors for those partaking in insider trading to sell to or buy from, and insider trading would effectively eliminate itself.

Another argument is the unfair treatment of those that don’t possess the information as a consequence of those who exploit the inside information. It robs the investors from attaining full value for their securities. If non-public information released throughout the market before an insider trading situation took place, the markets would integrate that information and the securities in question would become more accurately priced as a result. For example, say GlaxoSmithKline is having success in Phase 3 trials (final phase of clinical trials for a new experimental drug) for one of its new drugs and will make that information public in a week this gives those with the early access of information an advantage. Such investors could purchase the GlaxoSmithKline stock before the public release of the information and benefit from a rise in the price once the information goes public. The investor who’s sold the stock lacking the knowledge of the success of the Phase 3 trials might have saved his or her stock and could’ve benefited from the price appreciating if the success in the clinical trials was widely known.

INSIDE INFORMATION AND MARKET EFFICIENCY

James Surowiecki, the Staff Writer for The New Yorker, claims insider trading is an “inefficient way of achieving market efficiency” due to insiders gaining all their profits on the lag between when they start selling to when the market figures out what's going on (when the information is released publicly). He says “Markets thrive on transparency, but insider trading thrives on opacity”. It can be argued however when the demand arises for a certain stock this doesn’t go unnoticed and when the market realizes will capitalize and the price will move accordingly. Robert W. McGee, Ph.D., JD, DSc, MST, Professor of Accounting in the Andreas School of

Business at Barry University took this approach of argument defending insider trading and added "...Insider trading serves as a means of communicating market information, which makes markets more efficient”. As much as those with the information in advance have an advantage it can be argued through their actions of capitalizing on this step ahead indirectly gives information to those who are unaware in a sense making them apparent for example in the above diagram you can see the demand for the stock rising largely around 3 months before the announced but you can see it begins to drastically increase as the days near as the market is now aware something is going on. Inside information can be argued then is not so one-sided.

POLICY RESPONSES

Procedures and policies are present to prevent insider trading and protect the potential victims of such actions. The Securities Exchange Act of 1934 bans the misuse of material, non-public information. Many companies and mainly regulators enforce such policies and penalties to ensure such unlawful acts are prevented. Such policies are present to protect companies, directors, and employees who can be directly or indirectly harmed by the actions taken out, mainly financially for both parties. Most companies have penalties in place to reduce the incentives for such actions. Jail sentences, disgorgement of profit and fines are examples.

MARKET MANIPULATION

Market manipulation is spreading false information or conducting transactions designed solely to affect market prices. It’s a deliberate act of either inflating or deflating the price of a security or otherwise influencing the way the market behaves for the personal gains of the individual instigating the manipulation. it’s illegal in most cases however it’s difficult for regulators to detect.

MARKET MANIPULATION AND IMPACT ON THE MARKET ITSELF

In a manipulated market, prices won’t reflect the truth regarding current economic conditions affected by the demand and supply. According to studies of the stock market in Taiwan the stock prices are abnormally high during periods of manipulation.

There are studies that tell us how manipulations can impact the market:

Hoang (2007) found that the actions of manipulating stocks had a domino effect consequence across the market, he says to achieve 70%+ cumulative abnormal stock returns there’s increase in trading volume, as well as increased volatility causing liquidity to rise during these periods. It’s said to worsen market depth which means the market efficiency will also worsen making the unpredictability and volatility of the market to increase which can be consequential to entities within a market.

Wu and Aggarwal (2004) offered empirical evidence on the manipulation of stock prices within the US. They found out that securities with low liquidity were vulnerable to price manipulation increasing the volatility of price manipulation.

MARKET MANIPULATION AND ETHICS?

Like insider trading through market manipulation, the main goal is the profitable outcome that is gained through misleading. Investors will purchase illiquid shares are low value and then to drive up the price they can use techniques such a boasting about the share using varieties of identities or others to spread misleading rumors giving the impression of a worthwhile investment. As a result, the prices will rise as other investors are tempted to buy in, at which point the one behind manipulating would see at the high current price getting his profit margin leaving those who have currently purchased at a loss once the realisation kicks in of the share not being of the quality which was expected. This type of market manipulation is called “pump and dump schemes” or “ramping”.

Market manipulation is definitely unethical as it uses those without much knowledge or experience regarding a company/ share as a means for the manipulator to become profitable whilst the victim is misled to invest and lost money in the process. Insufficient information and asymmetric information are examples of market failures and can be seen as primary causes of market manipulation.

ROGUE TRADING

Rogue traders are those who act irrationally and independently of others usually at the cost of a firm that employs this trader. Rogue traders normally are linked with high-risk investments meaning there is the potential for huge losses or gains. It’s worth noting that these kinds of traders are only labelled “rogue” if their trades endure huge losses.

WHAT ARE THE IMPACTS OF ROGUE TRADING?

The main impacts are for a firm that the trader is with as they bear the brunt of the loss if the trade goes south and a large loss is taken on. For example, in the year of 2012, a US investment bank lost $6.2 billion, “Build up in an outsize position in an obscure corner of the credit markets. Ultimately, the position proved devastating for the bank. It was said that this practice started five years” (https://financeandriskblog.accenture.com/regulatory-insights/regulatory-compliance/regulatory-implications-of-rogue-trading) the loss incurred can take years or even decades to undo and come out of; these traders tend to look at the potentially high returns on a high stake/ risk investment opportunity over the ethics and loss which can occur.

WHY DO IT? IS IT ETHICAL?

The main intention is for profitability, with rogue traders the assets/investment opportunities they target are of high risk. What does this mean? Well with high risk projects you as an investor can demand a higher risk premium due to the high chances of loss meaning with high risk projects or assets that are of high risk the yield tends to be of greater amounts than low risk or even risk-free investments such as that of the US treasury for example or government bonds to be broader.

Rogue trading can invite further issues due to the sporadic actions and the increased chances of failure when things do end up going wrong the trader in question may feel to undo this mistake made added risk is worth taking or even conceal the damage caused which further impacts the firm they work for which was the case for Nick Leeson.

MISREPORTING

Financial misreporting is the action of giving false or is accurate financial information regarding the company, for example, misreporting the earnings of the company so that losses can be concealed.

WHY DO SUCH THINGS OCCUR? WHAT IS THE GOAL?

There has been a number of high profile accounting scandals from companies such as Enron, World comes, Parmalat and Satyam. A study from Bragues (2008) says that the cause for such activities is due to the character and integrity of the CEOs who've been motivated by personal financial gains resulting from performance bonuses. Due to the selfish intent of looking out for oneself, there has been deliberate misleading of investors to protect bonuses linked to company share price performance. The only way to overcome this is for regulatory oversight and a reformation of CEO morals.

There are a number of goals behind misreporting, I'm going to use the case of ENRON to illustrate one goal; this is to cover up losses. Jeffrey Skilling, CEO at ERON committed security fraud, he hedged inflated asset values and kept millions of dollars in debt of the company book. You can see these actions were committed for a number of reasons, one of them is if information of such debt was to go public this will decrease the company's asset value and a share price which can be costly.

Another reason is for personal gains (sometimes involves a group of individuals), for this case I'm going to use the example of Robert Maxwell who was involved in a pension scandal involving £440m and affecting over 30,000 people. Are the actions of Maxwell and Killing ethical? Clearly not, in both cases, there are multiple victims and both using others as a means to benefit themselves. As much as the self-gains can be substantially great the impact caused along the way is devasting most of them which who have no control over the actions committed.

This type of behaviour should definitely be considered unethical as it plays with the trust of the people that put faith in the individual to carry out their job role. It jeopardizes the firm in question through misusing capital but also deceiving those within the firm and outside in the form of potential investors who look at the reports and rely on it to see the health/ progress of the firm.

HOW DOES THIS AFFECT THE MARKET?

Misreporting can have negative impacts on the market in the long term, mainly in the form of trust. If companies are misrepresenting their earnings and this occurrence becomes more and more frequent the status quo for investors will change. Truthful companies will be among the victims as if they're looking for funding's publicly through selling shares it'll be hard to execute such deals as investors will be very cautious with who to buy shares into as they won't know whether a firm that is showing good signs in performing is its actual figures or not, in the long run, trust and confidence will be low making it hard for some businesses to survive due to lack of funding's.