# Ethical Issues in Securities Markets

**Securities** include financial instruments such as stocks, bonds, and options. The issuer of the security is generally a large organization, such as a private corporation, government, or bank, while the owners may be include individuals or other organizations. Around half of American adults own at least some stocks or bonds, while an even larger percentage own these indirectly (through vehicles such as pensions or retirement accounts). However, as we will discover, the ethical issues concerning securities markets can have substantial impacts even on people who don’t own any stocks. For example, in 2008, the collapse of the U.S. housing and stock market (which led to a sharp increase in unemployment) was plausibly due in part to investment decisions made by commercial and investment banks, and to actions by the government agencies responsible for formulating and enforcing policies concerning securities markets.

## What’s Wrong With Insider Trading?

According to the SEC, illicit **insider trading** involves “buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security.” However, the SEC (like most other agencies, both in the U.S. and abroad) have declined to say what *exactly* counts as insider trading, primarily because of worries that, if they do so, people will take advantage of the rule to “cheat.” Because of this, it is often up to individual courts of law to decide what counts as “insider trading” in a given case. However, the general *idea* of insider trading is perfectly clear—it occurs when a person “takes advantage” of their position as an “insider” to make favorable trades on securities markets. Importantly, this sorts of trading only works because someone *else-­-*the person the insider trades with—is NOT privy to this information. Jennifer Moore (1990) offers a survey of several common arguments for prohibiting insider trading, and points out some possible limitations with them, before eventually offering her own argument against the practice:

* **Arg 1: Insider trading is wrong because the two parties do not have *equal* information. The insider has more information.** Problem: In almost *any* trade, people don’t have equal information. For example, I may find a valuable antique toy car (which I know is worth $200, because I spend all of my time researching antique prices) at Goodwill, and pay only $15 for it. This doesn’t seem unfair, however, unless the trade violates some other duty (such as a fiduciary duty). For example, if I worked at Goodwill, and was the one responsible for *pricing* the item, this would raise moral problems.
* **Arg 2: Insider trading is wrong because the two parties don’t have *equal access* to information. The insider has the information that is simply *unavailable* to outsiders.** Problem: While this solution deals with the Goodwill case OK, there are still problems. Specifically, there is almost always *something* an “outsider” could do to become an “insider.” For example, health care professionals (by virtue of their training) have access to information regarding the treatment of disease that their patients do not. In fact, this is precisely the reason we pay them! Moreover, if a patient wants to become a health care professional, they are free to do so (they just need to go back to school, etc.). Again, this only becomes a problem if the information is *misused—*the doctor orders unnecessary tests, prescribes unnecessary drugs, lies to patients/the insurance company, and so on. However, simply making use of one’s “insider” status to benefit financially doesn’t necessarily raise moral problems.
* **Arg 3 [“Misappropriation Theory”]: Insider trading is wrong because it involves *stealing* from the firm’s owners.** Problem: In cases where firm owners prohibit their employees from using private data to make investments, this view works fine, and courts have often relied on it to get convictions. However, some proponents of insider trading have argued that firms ought to actually *encourage* this behavior, since it would provide their employees with incentives to “create” new information—regarding new products, markets, or organizational structures—that would allow them to benefit from insider trading. [Moore disagrees with this---see below for her reason why.]
* **Arg 4: Insider trading is wrong because it harms ordinary investors, as well as the market as a whole.** Problem: While insider trading may harm some ordinary investors (e.g., a person who sells to an insider at a low price, not realizing the price will go up in just a few days), it helps others (e.g., a person who sells quickly in response to market changes brought on by an insider’s trade, thus avoiding losses when the prices goes down in a few days). More generally, the fact that ordinary investors tend to not *like* insider trading isn’t much of an argument for or against it, absent some evidence they are actually harmed by it.

**Moore’s Argument: Insider trading is wrong because it undermines the fiduciary relationship in a way that harms firms, their owners, and society as a whole.** Moore argues that allowing insider trading would provide strong motive for managers and employees to act in ways that could harm both the firm’s owners and other stakeholders. She gives a number of examples: employees may “bet against the firm” by using negative information, start (positive or negative) rumors to affect the firms’ share price, “free ride” off fellow employees by making insider trades based on their actions, and generally begin to care more about setting up good insider trades than actually *doing their job.* If this sort of behavior became common among managers or directors, it would become increasingly difficult for shareholders (or even for taxpayers) to trust that the people they paid to do the work would actually do it. In the end, Moore thinks that allowing insider trading would make markets less efficient by making it more difficult for stakeholders to *cooperate with* and to *trust* one another.

Figure 1 Two notable examples of insider trading. From http://blogs.reuters.com.

## Is there a Problem With Derivatives?

A **derivative** is a broad class of securities whose values depend on (or are “derived from”) the value of something else. Traditionally, derivatives have been used to hedge against risk. For example, a farmer might enter into a **futures contract** with a corn merchant at the beginning of year that agrees to sell the corn harvested at the end of the year for an agreed upon price. Here, the value of the futures contract is derived from the (predicted) value of the corn. This limits risk for both the farmer and the corn merchant, who might be put out of business if the price of corn went too low (or too high). Similarly, people have long traded **options** (including “put” and “call” options) that give the buyer of the option the *option* to sell or buy a security at a given price at a given future date, and the seller of the option the *obligation* to purchase or sell that security, respectively. Among other things, options allow one to **short** a security, and to make a profit if the price of the security goes *down* in the future. In the 2008 financial crisis, **mortgage-backed securities** (derivatives whose value rises or falls based on the values of home mortgages) played a significant role.

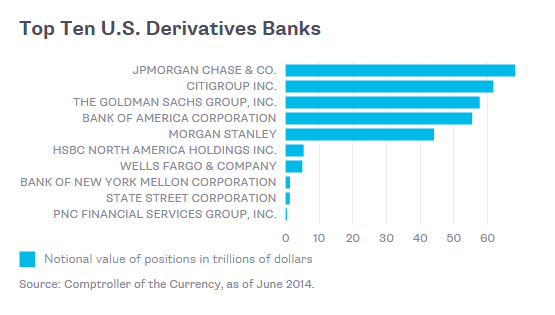
**What are “over-the-counter” derivatives? Why are people concerned about them?** Many of the derivatives mentioned above can be purchased in ordinary markets by ordinary investors, just like many stocks and bonds. However, so-called “over-the-counter” derivatives are NOT available on markets, but are instead exchanged *directly* by individual parties (the vast majority of derivate contracts involve investment banks or insurance companies as at least one of the two parties; **hedge funds** also make significant use of derivatives). These include **swaps** (where two parties “swap” debt-related obligations). In some circumstances, this can be very useful: One way in which commercial banks have used these sorts of derivatives risks is in efforts to diversify and limit the risks due to defaults on loans. So, for example, a local bank in a small town might use swaps or mortgage-bases securities as “insurance” against events that might cause widespread mortgage defaults in their local area, such as the major employer closing. This allows *individual* banks to lower their day-to-day **volatility** of their overall portfolio, and be able to make more accurate predictions about their future financial situation. Sounds good, right? Unfortunately, as it turns out, the widespread use of these derivatives may have also increased the chance of a huge, system-wide failure where *all* the banks were suddenly in trouble.

Figure 2 In the U.S., most derivatives trading involves a relatively few number of very large banks. However, these banks also play an important role in the U.S. financial system. From http://www.bloombergview.com.

**The Problem.** Because OTC derivatives haven’t traditionally had the sort of margin or reserve requirements that characterize many security markets, they can also be used to make highly-leveraged “bets” that can’t realistically be paid out if things go wrong. Moreover, because they are often very complex (and they are not traded on open markets, with lots of buyers and sellers contributing information about prices), it can be very difficult to determine what exactly they are “worth” or how large the risks actually are. So, for example, a bank may use a swap to effectively “bet” $1,000,000 that there is only a 1 in 100 chance of something bad happening. If all goes well, they’ll earn a little extra money. If disaster strikes, however, they owe $100,000,000, which may well bankrupt the bank. In 2008, derivative contracts had a face value of somewhere near $600 trillion dollars (by comparison, gross world annual product is only around $75 trillion, and total world wealth is only a few times this). When the housing markets crashed (and people defaulted on their mortgages), this caused an even *bigger* loss for housing-related derivatives, most of which involved investment banks. If the government had not stepped in, it is possible the banking sector as a whole would have collapsed (or nearly collapsed), which might have had disastrous consequences, even beyond the severe recession that followed.

**OK, So What Does All of This Have to Do With Ethics?** In 2010, the U.S. Congress passed the Dodd-Frank Act, which required that most trades involving OTC derivatives be reported to the SEC (which is similar to way most other securities are treated). It also required that investment banks hold higher reserves of capital to pay out potential losses, restricted banks’ risking FDIC-insured money (savings accounts, CDs, etc.) when trading derivatives, and required that banks make plans for “orderly” bankruptcies that wouldn’t threaten the economy. These rules have been a major source of political conflict, with many people thinking they should be strengthened (“Commercial banks shouldn’t deal with derivatives at all,!”), others thinking they should be weakened (“Derivatives are a smart way for commercial banks to safeguard customer’s money!”), and others wanting to leave them just as they are. On a more individual level, the use of derivatives raises a fundamental moral problem: on the one hand, making widespread use of derivatives might be better for *individual firms* and their customers*.* On the other hand, however, it might be bad for society as a whole, since they increase the chance that the government (and the taxpayers) will be forced to “pick up the pieces” when things go horribly wrong. What’s a banker to do?

## Should We Trust People With Their Own Money?

Now, on to a considerably less technical problem: To what extent should firms (or governments) trust people to make their own investment decisions, especially when this involves saving for retirement? While this may seem like an easy question (“Of course they should trust them!”), the problem is that ordinary investors, on average, do *much, much* worse than either the overall stock market or public pension funds. (Over the course of a career, this might mean retirement savings that are 75 to 80% below what they could have been.) The reason is that individual investors make human mistakes: they buy and sell stocks at the wrong times, don’t maintain adequately diversified portfolios, make mistakes that force them to pay unnecessary taxes, and so on. Similar problems plague other major markets: people take out unwise home mortgages, they invest in risky assets (gold, real estate) that seem more “real” to them, and so on. There are a number of important debates related to this:

* **Should ordinary investors be able to trade on securities markets?** With the rise of online brokerages (such as ETrade, Fidelity, Charles Schwab, etc.) it has become much easier for ordinary individuals to buy and sell many types of securities. Unfortunately, this also makes it easier for them to lose significant amounts of their money. Some scholars have suggested that, in response to these serious risks, the government should require some sort of licensing or regulation to trade on securities markets, with the idea that ordinary people who want to invest would need either to (1) work with a qualified professional or (2) take some sort of class and/or licensing exam. While this view has remained relatively unpopular, it is worth noting that many governments take (fairly drastic) steps to limit citizens’ abilities to gamble large amounts of money, for somewhat similar reasons (gambling addicts tend to harm both themselves and others).
  + **A potential problem for this view?** Restricting trading to “professionals” would likely raise costs for ordinary investors, and might very well push them into investments that are actually *worse* than stocks.
* **How much control should employees exert over their employees’ 401k/403b (retirement) plans?** A different form of the same dilemma arises in the context of the retirement plans offered by many organizations. On the one hand, allowing employees too much freedom will allow them to make unwise decisions (see above). On the other hand, organizations are prone to making self-interested decisions that can harm their employees (i.e., invest all of their money in the company’s stock). Finally, even when organizations are well-meaning and hire professionals to “manage” their employees’ funds, the fees paid to these managers mean that at least *some* of their employees (those who would have made wise investment choices) are worse off than they could otherwise have been.
* **Should Social Security be “privatized”?** Most retired Americans receive a significant portion of their income from Social Security, which is (in effect) funded by tax collections from *current* and *future* workers. This system is designed to minimize risk (and to minimize administrative cost), with an average retiree getting something like a 3-4% annual return on the “investments” they made by paying taxes during their career (though these aren’t really investments in any traditional sense). Some conservative thinkers have argued that we should replace this system with a “private” retirement system, where workers would *choose* which securities to invest their “Social Security” money in.
  + The Argument For: Over the last 120 years or so, the stock market has averaged around 7% annual return. So, this change might well increase the average income for retirees (so long as they invested wisely).
  + The Argument Against: If the government stopped collecting “traditional” Social Security taxes, it would have to borrow significantamounts of money to pay current retirees’ benefits. Even when the transition was complete, there would be significant risks, such as long-term stock market downturns or unwise investments by workers. If this happened, the government might have no choice but to spend even more money to “bail out” these workers (unless it wanted to allow mass poverty among the elderly).
  + Note: There is a general consensus that *something*  needs to be done to address the fact that, as our population ages, there will be less workers paying into Social Security and more retirees collecting from it. There are a number of solutions that economist have suggested would work (regarding retirement age, contribution levels, payment levels to rich retirees, etc.). However, there has been political deadlock over these issues for a number of years (this is somewhat understandable, since almost any solution is going to make *someone* unhappy).

## Review Questions

1. Suppose that your close friend tells you that the small company she works for has just made a major breakthrough, which the company hasn’t yet announced publicly: they have invented a new product, signed a contract to open new locations, etc. She’s very excited, and tells you “I know I probably shouldn’t have said anything, but the board thinks our stock price is going to double in the next three months, and we all will get year-end bonuses!”. **Given this knowledge, do you think it is *morally OK* for you to go home and invest in the company’s stock? Does it make any difference whether you have received your friend’s “permission”? Why or why not?**
2. Some people have argued that the banks (in the run-up to the 2008 crisis) who issued risky mortgages and traded in risky derivatives did so only because they *knew* the federal government would be forced to bail them out if things went wrong. The government has already won several multi-billion lawsuits against these companies (primarily related to misrepresenting how risky mortgages were to federal insurance agencies). However, almost no *individual* has been charged with wrongdoing. **When, if ever, do you think that we should hold *individual* executives criminally responsible for the financial “misdeeds” of their company?**
3. Do you think that Social Security should be privatized? Why or why not? (This may require doing a bit of outside research).