Ethical Behaviour and Securities Trading

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“Economic man does not ask himself ethical questions”. Yet securities trading inevitably raises many ethical issues, and ethical behaviour may be restricting and costly. Drawing on his economics background and his executive experience in the insurance and pension investment industry, as well as supervisory positions on the European Option Exchange, Dr Goslings analyses the securities markets and their structure, and explores their moral strengths and weaknesses in The Netherlands and elsewhere, before offering some practical recommendations. He has held part time professorships at Erasmus University and Maastricht University teaching finance and is currently preparing a new course on risk and insurance. He is also active as an independent consultant at Wentholtweg 26, 7214 EG Epse, The Netherlands.

Ethical questions have come to play a significant role in the way society expects economic agents to behave on securities markets. This interdependence requires a joint analysis of the structure of security markets, the behaviour of market participants and ethics. What sort of logic or rules do we apply to derive an answer to the question “is that ethical”?

One approach would be to list the issues presently under discussion and give an opinion on them. This seems an eclectic approach. I prefer to base my arguments on foundations. By the very nature of the subject these arguments must be personal and subjective. Since ethics has to do with the interaction of people I will formulate a behavioural model as a starting point. I will then say a few words on the changing values through time. This will give us some humility and avoid being too high minded and absolute in our statements as to what is ethical and what is not. Finally I will try to apply these insights to securities trading in general, and specifically to the Dutch situation.

Ideally the result of the analysis would be the identification of variables or proxies to measure ethics. My conclusion is that transparency of security markets comes very close to being such a proxy. Transparency can be defined, measured and supervised.

A behavioural model

In the area of business administration the application of behavioural models was pioneered by Simon (1957) who showed that the assumption of profit maximizing behaviour at the organizational level was not a good description of actual behaviour. His model was derived empirically. I will start at a more basic, psychological, level. That approach makes it an analysis of personal behaviour, not organisational behaviour.

It is relevant to note that *homo economicus* does not ask himself ethical questions. Self interest and wealth maximization are his only guidelines. This is not a complete description of the world and it leads to models which do not explain actual behaviour. Behaviour which is logical for *homo economicus* may be socially unacceptable.

Drives

I start with the drivers of human action as proposed by Freud. These drivers are also well recognized in Eastern philosophy. At the lowest level he starts with the id, the instinctive drive. In the Freudian world it is libido. In financial terms it is greed, the urge to make as much money as possible. If that drive leads to action it may socially not be
acceptable and can be considered to be unethical behaviour. The drive itself is not necessarily unethical, it is part of human nature. It falls outside the domain of ethics and might therefore be called amoral instead of immoral.

Drives may also take a more benign form. The dominating force becomes what Freud calls the ego. At this level drives are transformed into socially acceptable behaviour. People make love and earn money without disturbing common values. Again, what these values are and how they change over time is more difficult to determine. One line drawn between the acceptable and unacceptable is the line drawn by law. Above this level of socially accepted standards we enter the domain of the superego, everything that is expected of the higher nature of man. We may find ethical behaviour in the domain of the ego and the super ego. However we need a second variable for a more detailed delimitation.

Methods
Not only drives determine the content of our actions. The question of the methods applied should also be answered. Under the term fairness I group the two most important ones for our purpose: the positive ‘honesty’ and the negative ‘abuse of power’. Information is in this context the instrument of power. If we combine an acceptable drive with a dishonest action or a method in which power is abused that action may be termed unethical. Drives may be very difficult to observe, but methods are more open to observation. They become an important element in defining what is considered to be ethical.

Action and results
The action combines drives and methods from which emanates behaviour which must be judged to be ethical or not. The result follows from the action but is not part of it. At the moment the action is taken the result of that action is still uncertain. Logically the result can therefore never be part of our consideration on the ethical nature of behaviour. Making losses while using insider information is quite possible. That act is not less unethical than in the case where the expected profit was realized. This is a logical conclusion. Legal reasoning may lead to different answers, depending on the legal system which must be applied.

Summarizing, it seems that the three elements, ethics, law and social acceptability, are not mutually exclusive. For example, an unethical action may be allowed by law, the application of law may have unethical consequences or socially acceptable behaviour may be illegal and unethical. Not reporting interest income for tax purposes is an example of socially accepted behaviour which is both illegal and unethical by the test of honesty. Present Dutch law makes it almost impossible to convict for insider trading, making unethical behaviour in effect legal. Outside the area of finance many more examples are possible.

Which standard for whom?
It will not be easy to define standards precisely as we are operating on a sliding scale. In our case a further obstacle is the fact that finance deals with non-physical entities. In industry it is much easier to get a grip on a physical product; it can be tested, measured and replicated. In securities trading questions are: what was said, what was suggested, what did parties know at a certain moment? The concept of transparency will be used to get a grip on these items.

To what level should we raise ethical standards? Dodd observed in 1932 that the purpose of ethical management is “to catch any new spirit” and embody it in voluntary standards “without waiting for legal compulsion” (cf Stark 1993, p. 39). However the Conference Board study 986 (1992) shows that in 25% of cases new laws were the reason for European companies to change their internal ethics statements.

In my earlier analysis I linked socially accepted drives and fair methods with ethics. Let us now assume that society is not homogeneous and made up of subgroups. This may mean that different sets of values coexist. To one group the combination of drive and method may seem ethical, to another it may seem unethical. If there is an interaction between non-homogeneous groups clashes about what is and is not ethical may occur. For example, behaviour which is acceptable between professional securities traders may not be acceptable if a professional is trading with the public as in over-the-counter (OTC) markets.

Finally we have a problem of human weakness. Are people able to analyze their own behaviour in an analytical way? Few people will tell you they behave unethically. All you may learn from the outside is a different judgement about what is ethical and what is not. The fact that people don’t realize they are behaving unethically, or
are trying to hide it either consciously or unconsciously, makes it quite difficult to set common standards and to enforce them. We can’t easily observe what we want to define. I fear that the Jekyll and Hyde-syndrome is much more prevalent than many tend to think.

Ethics and economics

As a next step I propose to link ethics to economic variables. In finance we draw efficient frontiers, the line indicating the highest return given the level of risk. An investor will always select an investment portfolio on that frontier because it gives him the highest possible return given the level of risk. What level of risk he chooses depends on his preferences. In ethics we may define a similar efficient frontier; the highest return given the level of ethics. It is well recognized that behaving at a higher ethical level reduces degrees of freedom, causing lost opportunities and reduced returns. This argument is very general and applies to individuals as well as corporations. Monopolistic behaviour for example is an obvious case of abuse of power with the sole purpose being to increase returns. In the Western world legislation to reduce the degrees of freedom is well established.

I have chosen for the straightforward argument that higher levels of ethics reduce returns. It may be argued that this is a short term effect and that in the long term it might very well be that the public values these higher standards, leading to higher returns on the long run. This dynamic consideration is not taken into account. The driving forces of the dynamics, like dissemination of information, merit separate analysis.

As we increase the level of ethics, returns get lower. However, if we move into the area of socially less acceptable behaviour the returns will first increase but then fall, for two reasons. When we go beyond the law we must reckon with legal cost and eventually punishment. Also, counterparties will start to avoid unethical agents, reducing their return. Which point on this frontier a person selects depends on his utility function. Such a function, however, is a theoretical construct and gives no real-world answers. However, given the id-drive, there might be a natural tendency to increase return and lower ethics until legal limits are reached. This is the raw application of the profit maximizing principle at the individual level; the behaviour of homo economicus.

This may not be acceptable, however, for various reasons. Groups, in our case the financial community, may set higher standards out of moral conviction, after pressure from supervisors or just to stay ahead of outside pressure and changing laws. Again, these standards may vary between subgroups which make up that community. A quite interesting discussion has started in The Netherlands, where the former CEO of the European Option Exchange has argued that self-regulation cannot work because it is against the financial interest of the parties involved. It is an official statement that the ‘id’ dominates the ‘ego’ and the ‘super ego’. Homo economicus dominates homo ethicus.

The reason for outside pressure, which is clearly discernible throughout Western society, is difficult to determine. Somehow a greater openness of society has developed which exposes behaviour which went undetected in the past. That is an interesting observation because it links transparency in society with transparency in financial markets. If we increase transparency of markets the level of ethics is raised, because unethical behaviour cannot be hidden any more. Transparency is therefore an important objective for regulators. Brandon Becker from the SEC made that point in a lecture in London in 1992 when he stated ‘I want to outline why U.S. markets have concluded that the principle of transparency is a fundamental aspect of investor protection . . .’. In the United Kingdom the Securities and Exchange Board has taken the same position. Returning to economic definitions of market types, we may say that transparent security markets come close to perfect markets. Non-transparent markets provide informational monopolies to certain market participants.

We have now come to a stage where we have identified a number of attributes to describe ethical requirements: honesty, abuse of power, information and transparency. We have also seen that increased levels of ethics reduce returns. That makes it difficult for individuals to adhere voluntarily to these higher standards. Structural ways to assure general compliance must be looked for.

Structure of securities markets

In securities markets one finds basically two trading systems, the auction system and the dealer, or market maker, system. There are instances where the two types are mixed. For analytical purposes they are first treated as separated.
Auction markets

In auction markets demand and supply are brought to a single market. The price that clears the market is determined by demand and supply. Originally this was accomplished physically. Traders just met during a certain period at a certain location. Later the procedure was formalized in so-called open outcry systems as pioneered on the option exchange in Chicago. Today these markets are frequently electronic markets. If the flow of orders, the liquidity, is high, the price formation and clearing process may be continuous. Otherwise it is limited to a number of discrete moments in time. Such a market can and should be made transparent, so that all market participants have the same and all information about traded positions. That is information on quoted prices and volume in the order book as well as the prices and volumes of all transactions. The Paris bourse offers through CAC such a transparent trading system (cf. Biais, Hillion and Spatt 1995).

Auction markets are the preferred type of market from an ethical point of view. By their design these markets, if properly implemented, are fair because all information is available to all participants and everything that is done is visible. Sometimes the term ‘blue sky trading’ is used. Supervisors should take all possible action to ensure that these markets will continue to exist and function. They should also make sure that transparency at the highest possible level is attained. This is of particular importance to protect the public and enforce acceptable levels of behaviour. A legal requirement to trade orders of the public on such supervised markets is recommendable.

Dealer markets

In the dealer system a dealer buys from one client and then searches for another client to sell at a higher price. The dealer must hide information about his positions, otherwise his margin is jeopardized. There is structural non-transparency in this type of market. Cynically one might even say that this type of market is based on insider trading. The system may lead to unethical behaviour as the dealer is maximizing his return. There are many cases of such behaviour which have made headlines, a notorious case being that of Salomon Brothers cornering the market for a treasury issue. The danger is particularly acute if professionals are trading with the public. All OTC-markets are dealer markets. Ross (1990) gives an historical survey of how dealers used their proprietary information on trades to generate profit. He also indicates how transparency which can be provided by electronic systems endangers this position.

As dealer markets have drawbacks we must answer the question: why do they exist? The most obvious reason is: they exist because of the interest of dealers. Dealers also develop proprietary and tailored products to attract clients. These products can by definition not be traded on auction markets and thereby protect the dealer against transparency. Another reason is that some institutions require immediacy. They want large orders to be executed immediately without disturbing the market. Dealers provide that service. Of course there is a price to be paid for immediacy. Why people want immediacy is not always clear. One reason may be that they have information the trader does not have, adverse information. Outwitting a dealer may be not so bad at first thought, but it is the mirror image of the dealer outwitting his client. In this cloak and dagger game it is far from clear who is at the winning end. Such a market can hardly be called fair and orderly. Unethical behaviour is part of the game and it is not easily detected.

Mixed systems

Sometimes characteristics of auction and dealer markets are mixed. Within the auction market traders are given the function to maintain markets if liquidity becomes insufficient. These traders are called specialist. The system is found on the NYSE and has been copied in Amsterdam (ASE). The specialist trades for his own account and to allow him to do so at a profit transparency is sacrificed. Problems with dual trading are identified and researched on US-markets (cf Park, Sarkar and Wu 1995).

From an ethical point of view this system is to be denounced. If the functioning of the markets requires a specialist supervisors should make very sure that he does not abuse his powers based on superior information given to him. Personally, I prefer the saitori-system as it functions in Japan. Exchange officials, saitori, stop trading as liquidity dries up, and solicit and collect orders to restart the auction process as conditions improve (cf Lehmann and Modest 1994).

Setting and maintaining ethical standards

As ethics is a matter of personal conviction, individuals may behave ethically. However
this will not easily lead to common values and group behaviour at high ethical levels, the reason simply being that there is a strong financial incentive to act less ethically; bad behaviour drives out good behaviour. The dilemma can be solved in a compulsory or semi-voluntary manner. However, as we have seen, market structure also makes quite a difference.

**Supervision**

Supervisory authorities have little direct power to determine market structure. Given market structure they will regulate in such a way that minimal ethical levels are maintained. The objective is protection of the public by maintaining fair and orderly markets. The type of measures can directly be derived from our analysis:

- licensing of people and organisations to control honesty
- requiring pre- and post trade information to be made available to the public immediately or with minimal delays
- requiring professionals to ascertain that their non-professional counterparts fully understand the trades and resulting positions
- separating advisory functions from trading functions
- assuring that the public has access to all information relevant to share prices; this includes defining and prohibiting insider trading.

**Self-regulation**

Self-regulation has a long history. It centred around exchanges. Its members acted as a guild and could enforce internal standards. In a sense it was a method to maintain their monopolistic position. Dealers do not form such a natural guild. Still, both members of exchanges and organisations of dealers have tried to set ethical standards. In the case of dealers these standards tend to be codes of conduct, not easily enforceable. If the group has more formal ties like being member of an exchange, the rules may be enforced through disciplinary law. The use of the word ‘guild’ already suggests something from the past. With increased competition between exchanges and dealers, between members of exchanges with different interests and between different markets in different countries and jurisdictions it gets ever more difficult to define and enforce common standards.

**Market structure**

I feel the role of market structure in maintaining standards is not yet generally recognized. We have seen that transparent auction markets almost by their nature guarantee high levels of ethics. Particularly with the possibilities of electronic exchanges and the necessity in the European Union to restructure domestic markets, there is an opportunity to embed ethics in market design. This is one of the objectives of the SEC in the US (cf Schwartz 1994).

**Observations on the Dutch situation**

The analysis has been done in an abstract manner. I will now use the Dutch situation to demonstrate the applicability of the analysis to real world situations. But let me start with an anecdote which I feel is typical of the situation. A friend, an old fashioned very decent banker, was complaining to me about the widespread unethical behaviour in the financial community. As I indicated that this used to be the accepted practice in the past he answered: ‘you are perfectly right, but then only respectable people did it; now everybody does’. This is what I called the Jekyll and Hyde syndrome. However, it seems that during the last decade the visible adoration of money and greed has set new standards of behaviour.

**Exchanges**

The cases of the European Option Exchange (EOE) and the Amsterdam Stock Exchange (ASE) are very different. The EOE is an open outcry auction system. Trading on the floor is not only transparent by design, it is also well regulated and policed. That does not rule out unethical behaviour but it is likely to be spotted and punished on the basis of disciplinary law.

Problems with behaviour are to be looked for at the level of public order members, that is, members of the exchange through whom the transactions of the public are brought to the trading floor to be traded by independent market makers. Basic requirements like proper advice and separation of advisory and trading functions are frequently not adhered to. The existence of a ‘complaint-council’ has provided a platform to examine and publicize improprieties. This may have served some educational purpose, but it would have been much better if codes of conduct had set the standards, and offenders had been punished.
The ASE maintains a number of trading systems. The retail market functions as an electronic auction system combined with specialists to assure continuity and liquidity. For the wholesale market a 100% electronic auction system is maintained as well as a Seaq-type quotation advertising screen. Seaq is the London dealer system where dealers advertise quotations to attract customers. As the latter two wholesale systems are for professional use only, their functioning has no impact on the public, and they will not be further discussed here.

The retail system has an intrinsic problem, because it is not sufficiently transparent. All orders except those with the highest bid and lowest offer are invisible to the public, and the specialist is given a 15 second period to trade each incoming order on his own account. This procedure is designed to protect the specialist. Although systems have been installed to monitor the specialist, the real question is whether a specialist is required.

As in the case of the EOE, the problem is most severe at the level of the members of the exchange interfacing with the public. I find it particularly worrying that major banks position themselves as investment advisors with the sole purpose of deriving trading income. That does not pass a simple test of honesty.

A particularly nasty problem is the question of in-house clearing. The banks wish to offset buy and sell orders. As long as this is done in a transparent manner based on rates from the auction market it may be acceptable. However, the drawback is that the procedure syphons off liquidity from that market. To allow banks to offset orders without transparency and to mix that operation with their own positions brings us into the worst of all worlds. Even the wish to do so already seems highly unethical. It amazes me that the supervisor has not participated in that discussion nor made its judgement public. Fortunately plans to introduce in-house clearing have been shelved for the time being, but for the wrong reasons. The French solution to make it illegal to trade outside the exchange makes a lot of sense.

A sensitive subject which must be addressed is the manipulation of prices in periods when new issues are brought to the market. This is an obvious case where markets are not fair, information is hidden and prices are manipulated to the benefit of a small group of market participants. Given the dominating position which these parties have both in the market place and in the board of the exchange, measures coming from that side are unlikely. Here clear guidance from the supervisor is called for.

The supervisor

The Stichting Toezicht Effectenverkeer (STE) is by law the supervisor of security trading. The STE has not yet taken visible steps to set and enforce ethical standards. This article has shown that there exist many practical tools to do so. Transparency is the leading instrument. It may be attained by market design, information requirements and concentration of liquidity. At the same time strict codes of conduct should be formulated and policed.

Particularly urgent is the situation around insider trading. This term is used here in the sense of outsiders, non-market personnel, who have inside information, usually corporate officers. Codes of conduct will be of no use in these cases, because there is no common interest to adhere to rules. The law should set the lower limit of ethical behaviour. Although insider trading is illegal, laws are written in such a way that even the most blatant cases of insider trading have not led to convictions in the Netherlands. The STE should cooperate closely with the Justice Department and the Ministry of Finance to set enforceable standards. New legislation is now in the process of being introduced.

Literature


