Maintaining Confidence in Financial Markets – Importance of an Ethical Framework for MNPI Disclosures, Stock-Based Compensation and Insider Trading

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Background

We blame ethical breaches in financial markets on greed, but without greed as an incentive markets would no longer function. People who "play the stock market" do so, because they believe they all have an inherent advantage or some unique knowledge or insights. Ethics with regards to financial markets have been based on the premise of "levelling the playing field" (Dhumale, 2001; Clausen & Sørensen, 2012), but as Oscar Wilde eloquently put it "Private information is practically the source of every large modern fortune". The problem is therefore cheating the system which undermines the very essence of financial markets and their integrity.

Whether material non-public information (MNPI) leads to insider trading, market manipulation, or otherwise allows those in possession of MNPI to gain monetary advantages. It is cheating which undermines the whole system of financial markets. Thus, the proverbial million-dollar question becomes how to stop the cheating, the ultimate form of unethicality. This is a critical problem for our society to solve. Markets exemplify the essence of capitalism – you work hard, think hard, outperform others and the result is financial reward. This underlies the whole system of financial markets and the process of price discovery, however, if cheating is prevalent the system self-destructs without investor confidence from the lack of belief in the system.

The coronavirus pandemic and subsequent government stimulus brought a copious number of new customers to online brokers this year from all around the world. This means retail participation is on the rise. With online brokers gamifying trading platforms to attract millennial and gen-Z investors, riskier derivatives are favored by younger investors, further putting them at the mercy of the cheats. This culminates in the very extreme cases of individuals committing suicide after racking up immense trading losses (Glossner, Matos, Remilli, & Wagner, 2020; Shrikanth, 2020).

Titman, Wei and Zhao (2020) has found widespread evidence of insider manipulation of share prices to exploit "naïve retail investors" in the Chinese stock markets. Examples of manipulative corporate behavior include stock splits as opportunities for insiders; to sell large blocks, or otherwise utilizing MNPI to manipulate share prices. Insider trading is then taking advantage of MNPI's. Overall, this presents a myriad of issues from damaging the reputation of markets, creating instability, inefficiency and causing financial harm to retail investors. Basically, large companies and brokerage firms gain from their professional knowledge at the expense of retail investors, which brings up another critical aspect of ethics; should professionals take advantage of amateurs, and is this behavior even more unethical?

The recent case of Kodak's loan news release from earlier this year (2020) surmises the key ethical dilemma as well as the potential impact MNPI's, insider trading and market manipulation on financial markets.

The Ethical Dilemma

The recent case of Eastman Kodak and its MNPI disclosure exemplifies the need to address insider trading and market manipulation. The ethical dilemma that surrounds the case of Kodak can best be summarized by the SEC investigation and numerous class action suits filed on behalf of investors. Kodak's case began as news was leaked early, by media outlets, about the imminent announcement of a "new manufacturing initiative" involving the U.S. International Development Finance Corporation (DFC) in response to COVID-19. As the Trump Administration awarded the former photography titan $765 million to begin producing pharmaceutical ingredients in New York.

Investors showed renewed faith in the stock that rocketed up from $2.6 to $60 per share when the loan was first announced (Michaels & Francis, 2020**).** Kodak exhibited a massive spike in trading volume after the announcement, at one point with a high of 284 million shares changing hands compared to the average trading volume of just over 230 thousand per day. As retail investors piled in, trading in the stock was halted 15 times due to excessive volatility (Stevens, 2020).

A legal investigation arose following alleged insider action as the CEO awarded several executives with high volume stock options right before the government loan was announced (Michaels & Francis, 2020, Hagens Berman, 2020, Stevens, 2020). As a result, the entirety of the loan was frozen while the SEC looked into Kodak's actions to determine if they were untoward or not. The announcement of the investigation caused the stock price to nosedive from the high of $60 per share all the way back down to single digits (Stevens, 2020). Thus, these actions have allowed insiders to profit immensely while causing unquestionable damage to investors who may have bought shares during this period.

On 1st August 2020, reports emerged of further previously undisclosed stock grant to Kodak's CEO. This had previously not been listed in his employment contract nor made public (DiNapoli & Bergin, 2020). The primarily allegation of the class action suits against Kodak surround these grants, and their suspicious timing around the disclosure of the $765 million loan, which they knew would have a materially positive impact on Kodak's stock once the deal was announced (Hammett, 2020; Singh, 2020).

Relevance to Society

Although the SEC investigation has since found there was no wrongdoing, investors were nonetheless harmed. This case, and others like it, brings up numerous issues surrounding material non-public information (MNPI), market manipulation and its impact on retail market investors. On a grander scale, whether repeat incidents such as this, where insiders profit from MNPI, fail to disclose related transactions and stock-based compensation, and ultimately manipulating markets by targeted timing of MNPI; will investors continue to have the confidence to invest in companies and markets. This particularly applies to small and mid-cap companies that are the most in need of the capital available from equity markets.

So, while Kodak's actions were legal, this presents the perfect opportunity to examine the ethicality with which the MNPI was disclosed, and also how and when stock-based compensation is awarded and how insider trading should be controlled. There are obviously very few ways to control the accidental release of news as human error can always be a potential flaw. This was the determination of the Kodak case. Also not highlighting the fact after the accidental release of information after calls of manipulation would be a way to avoid some ethical conundrums.

In terms of compensation and insider trading, had Kodak publicly disclosed ahead of time its compensation plans, or the mechanisms and/or milestones by which compensation would be distributed it would have avoided any claims of insider trading. This means that companies should have clearly reported compensation structures along with any stock price-based milestones prior and also public rules for how its employees, especially senior executives who are likely to be exposed to MNPI can conduct open market transactions of the company's shares.

A separate issue worthy of examination is how company employee transactions should be prioritized on the open market, and if such trades should even be allowed. Should employees of listed companies even be allowed to trade their company stock? And should these orders be prioritized the same way that other market participant's orders are treated?

Solution

Recommendations

Based on the examination of Kodak's case and the ethical issues which have arisen, a few solutions to these issues can be identified which reduce unethical behaviours in markets and ultimately improve efficiency and participants' confidence in markets.

In dealing with MNPI and associated conflicts of interests in disclosures, it should be mandated that any company employees possessing MNPI's must identify themselves to either exchange venues or securities commissions. Subsequently to prevent them and close relatives from making transactions on markets or those companies without prior clearance. In addition, it could be instituted that companies are not allowed to directly release MNPI's to news outlets, and instead must route this information through either the exchange or securities commission first, who then publishes the information or disseminates to news outlets as appropriate. This would serve to prevent future instances of accidental disclosures and also ensure that incidences of insider trading could be more easily identified and reprimanded, overall increasing investor confidence in markets regulation.

Further transparency is also required as it relates to how stock-based compensation is decided and the closely related issue of personal account trading. There should be a clear framework for how and when stock-based compensation can be issued, which should be made publicly available a suitable time before issuance. This framework could be produced by either exchanges or regulators. Stock-based milestones should also be identified perhaps on an annual basis, which cannot be modified throughout the year to improve

Conclusion

Insider engagement in practice distorts share prices and can artificially inflate trading volumes with the goal of misleading market participants. These recommendations for enhanced controls and regulation serve to prevent cheating and unethical behaviors in markets as they relate to insider trading and MNPI disclosures. But they also serve to create a stronger regulatory environment, which stimulates fairer and more transparent financial markets; which will ultimately improve market efficiency.

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