

65 Views | 34 CrossRef citations to date | 0 Altmetric

Research Articles

Ethics, Fairness and Efficiency in Financial Markets

Hersh Shefrin & Meir Statman

Pages 21-29 | Published online: 31 Dec 2018

🗨️ Cite this article <https://doi.org/10.2469/faj.v49.n6.21>

🌿 CFA Institute members: [sign in to access the Financial Analysts Journal.](#)

Sample our
Mathematics & Statistics
Journals

>> [Sign in here](#) to start your access
to the latest two volumes for 14 days

🗨️ Citations

📊 Metrics

📄 Reprints & Permissions

Read this article

We Care About Your Privacy

We and our 845 partners store and/or access information on a device, such as unique IDs in cookies to process personal data. You may accept or manage your choices by clicking below, including your right to object where legitimate interest is used, or at any time in the privacy policy page. These choices will be signaled to our partners and will not affect browsing data. [Privacy Policy](#)

We and our partners process data to provide:

Use precise geolocation data. Actively scan device characteristics for identification. Store and/or access information on a device. Personalised advertising and content, advertising and content measurement, audience research and services development.

List of Partners (vendors)

I Accept

Essential Only

Show Purpose



Ethics, Fairness and Efficiency in Financial Markets

Hersh Shefrin and Meir Statman

Do prohibitions against insider trading hamper economic efficiency or promote fairness? Financial market regulations are the outcome of a continuous tug-of-war between concern for economic efficiency and concern for fairness. This is demonstrated by the histories of six major regulations and the forces that have affected changes in the tradeoff over time.

People often disagree about the relative weights that should be assigned to efficiency and fairness. They also disagree on the relative ranking of fairness rights. For example, prohibiting insider trading violates the right to engage freely in trade. Permitting legalized insider trading violates the right to equal information. Which right ranks higher?

When laymen read newspaper accounts of insider trading, they think about *ethics*. When financial economists read about insider trading, they think about *efficiency*. The difference in perspectives usually translates into different prescriptions for public policy. What many financial economists seem to overlook is that the regulation of financial markets is shaped by considerations that go beyond efficiency or self-interest. These considerations include concern for ethics or fairness.

This article seeks to bridge the gap between the two perspectives as they meet in the arena of public policy. The regulation of financial markets in the United States cannot be understood without an appreciation of the continuous debate that has shaped it. Regulations are the outcome of a tug-of-war between efficiency and fairness, in which relative strength continually shifts from side to side.

This article describes the world of regulations as it is. Of course, not everyone agrees that the world should be as it is. Some people feel that too much emphasis is placed on fairness to the detriment of efficiency, while others feel that too little emphasis is placed on fairness and still others that some aspects of fairness are over-emphasized at the expense of other aspects of fairness. We seek to illuminate the process by which a balance between fairness and efficiency is struck by the citizenry through the legislative process. The shaping of regula-

tion is hardly confined to the history books. Serious debate is taking place today about stock market volatility, junk bonds and insider trading, and further debate is certain to continue.

FAIRNESS AND EFFICIENCY

What is fairness? One definition would hold that, in a fair market, all parties have equal access to information relevant to asset valuation, but are entitled to nothing more. This "mandatory disclosure" definition of fairness, however, cannot provide a framework for merit regulations, suitability regulations or margin regulations. A framework consistent with the reality of regulation requires a broader definition of fairness, as well as a classification of the various notions of fairness and efficiency that play a part in the debate.

Efficiency comes in two forms—Pareto efficiency and informational efficiency. *Pareto* efficiency exists when no other feasible allocation of resources and technology can improve one person's situation without harming that of another. Pareto efficiency ensures maximization of production by precluding the waste of resources. It also ensures that the riskiness of investment projects undertaken matches the attitudes of investors toward risk. Pareto efficiency does not imply, however, that investors make no mistakes. They might, for example, take on more risk than is objectively appropriate or overreact to information and cause security prices to be overly volatile.

Informational efficiency is achieved when all investors hold objective beliefs and information in common, so that competitive prices accurately reflect that information. Efficient prices provide proper guidance to entrepreneurs, managers and investors. By observing prices, managers can avoid projects with negative ex-

Hersh Shefrin is Professor of Finance at Santa Clara University (California) and a member of the editorial board of Behavioral Decision Making. Meir Statman is a Professor of Finance at Santa Clara University and a member of the Advisory Board of the Journal of Portfolio Management.

This article summarizes a monograph published by the Research Foundation of the Institute of Chartered Financial Analysts.



Log i

> Acc



Log

> Log

Resto

> Restore content access for purchases made as guest


Purchase options *

Save for later

PDF download + Online access

- 48 hours access to article PDF & online version
- Article PDF can be downloaded
- Article PDF can be printed


USD 53.00

 Add to cart

Issue Purchase

- 30 days online access to complete issue
- Article PDFs can be downloaded
- Article PDFs can be printed

USD 162.00

 Add to cart

* Local tax will be added as applicable

Related Research

People also read

Recommended articles

Cited by
34



Information for

- Authors
- R&D professionals
- Editors
- Librarians
- Societies

Opportunities

- Reprints and e-prints
- Advertising solutions
- Accelerated publication
- Corporate access solutions

Open access

- Overview
- Open journals
- Open Select
- Dove Medical Press
- F1000Research

Help and information

- Help and contact
- Newsroom
- All journals
- Books

Keep up to date

Register to receive personalised research and resources by email

 Sign me up



✕