

# Ethics In Insider Trading: An Analysis From A Deontological Perspective

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## Abstract:

From the time of inception of the new world order and from the beginning of the stock market itself, we have seen cases of insider trading which have had severe impacts on the style and strategies of investing. Insider trading is the trading of a public company's stock or other securities such as bonds or stock options based on material, non-public information about the company. In various countries, some kinds of trading based on insider information are illegal. This is because it is seen as unfair to other investors who do not have access to the information, as the investor with insider information could potentially make larger profits than a typical investor could make. In this paper we discuss the various aspects of insider trading, the steps taken by various regulatory bodies to curb the practice. It also discusses some popular cases of insider trading which led to formulations of stringent laws. The paper analyses Ethics in Insider Trading from a Deontological Perspective to highlight what should be the best ethical practice.

**Keywords:** Insider Trading, Securities, BSE, SEC, SEBI, Tipping, Kantianism, Deontology.

## Introduction:

Insider trading, the practice of buying or selling securities based on material non-public information, has long been a subject of ethical scrutiny. This paper aims to analyze the ethics of insider trading from a deontological perspective, exploring the moral principles that underlie this controversial practice.

Insider trading is a form of malpractice which involves trading of a company's securities by a person or a third party which has access to Material Information which has not been made public and it is only accessible to a handful directly related individuals for example corporate executives.<sup>1</sup>

The Securities and Exchange Commission (SEC) in the United States has described it as "a financial gain of 10 resulting from the purchase or sale of a security in violation of a fiduciary responsibility or

other relationship of trust and confidence, based on significant non-public information about the security."<sup>2</sup>

Material information refers to any information that has the ability to significantly influence an investor's decision-making process. To either acquire or divest the security. Non-public information refers to information that is not legally accessible to novice investors who are beginning from scratch or those with limited industry connections. The questions of legality arise from the Securities and Exchange Commission's endeavour to uphold a just marketplace. Individuals possessing privileged information would possess a significantly inequitable advantage over other investors and may generate substantial profits.<sup>3</sup> It's important for individuals involved in financial markets to adhere to ethical and legal standards, including refraining from engaging in insider

<sup>1</sup> <https://economictimes.indiatimes.com/definition/insider-trading>

trading. Companies often have policies in place to prevent and detect insider trading among their employees, and enforcement agencies work to maintain fair and transparent financial markets.

### **Definition of an Insider under Jurisdiction:**

Some consider only direct access, while others may consider people related to company officials as insiders. According to the Securities and Exchange Commission, even third parties can be considered insiders. This process is known as stepping tipping. Any insider can also be defined as a director or senior officer of a publicly traded company, as well as any other person or executive who has access to material information that is not in the reach of common investors.<sup>4</sup> “An “insider” is an officer, director, 10% stockholder and anyone who possesses inside information because of his or her relationship with the Company or with an officer, director or principal stockholder of the Company. Rule 10b-5’s application goes considerably beyond just officers, directors and principal stockholders. This rule also covers any employee who has obtained material non-public corporate information, as well as any person who has received a “tip” from an Insider of the Company concerning information about the Company that is material and non-public, and trades (i.e., purchase or sells) the Company’s stock or other securities.”<sup>5</sup>

In certain jurisdictions, the definition of an insider may extend to family members of company insiders. This is to prevent individuals from using close relationships to exploit confidential information for personal gain.

“This policy also applies to your family members who reside with you, anyone else who lives in your household, and family members who do not live in your household but whose securities transactions are directed by you or are subject to your influence or control, as well as trusts or other

entities for which you make investment decisions.”<sup>6</sup>

### **Tipping:**

It is illegal to share confidential information about a publicly traded company with someone who is not authorised to have that information, as long as the person receiving the information knows or suspects that the person sharing it is violating a legal duty and the person sharing it gains some form of profit, favours, or benefits from the sharing. If the tipper transfers information to another individual with the anticipation of receiving any financial advantage, it will be regarded as insider trading.

As per the SEC, individuals who get non-public information through a family member, who in turn obtained the sensitive information from a friend, will all face legal prosecution. Even though “insider-trading generally has a negative connotation there also exist legalised insider trading methods.”<sup>7</sup>

### **Legal Insider Trading:**

Legal insider trading is common among companies, where directors have the ability to buy or sell shares. However, they are required to disclose all information regarding these transactions. As per the regulations outlined in the Securities Exchange Act of 1934, the initial requirement for legally disclosing a transaction is to electronically submit all relevant information to the SEC.<sup>8</sup> Additionally, this information must be declared on the official website of the company. Furthermore, directors and managers are obligated to disclose any transactions within the company within two days of the purchase or sale.

For insider trading to be legal three forms have to be filled which have been mentioned underneath:

<sup>2</sup> Ganti, Akhilesh. 2023. What Is Insider Trading and When Is It Legal? Accessed on October 2, 2023.

<https://www.investopedia.com/terms/i/insidertrading.asp>

<sup>3</sup> Insider Trading. Accessed on February 26, 2023.

<https://www.investopedia.com/terms/i/insidertrading.asp>

<sup>4</sup> SEBI Regulation 2015. Accessed on March 20, 2023.

<https://www.latestlaws.com/bare-acts/central-acts-rules/corporate-laws/the-securities-and-exchange-board->

<of-india-act-1992/sebi-prohibition-of-insider-trading-regulations-2015/>

<sup>5</sup> Insider Trading Policy. Accessed on March 27, 2023.

[https://www.sec.gov/Archives/edgar/data/1164964/000101968715004168/globalfuture\\_8k-ex9904.htm](https://www.sec.gov/Archives/edgar/data/1164964/000101968715004168/globalfuture_8k-ex9904.htm)

Form 3: It is the initial filing showing a stake in the company.

Form 4: Includes disclosure of a transaction by any high-level company executive or director or any person with access to insider information within two days of the transaction that is the purchase or the sale of security.

Form 5: Form five ensures the record of earlier transactions of the company insiders of those that had been deferred in the past

“All these are extremely helpful as well as necessary for investors to research the insider ownership of a company, as a company with economic success can also be determined by the stakes of its executives, as well as outright ownership transactions such as equity swaps that may hedge the economic risk of ownership.”<sup>9</sup>

### Hypothetical Examples of Insider Trading:

- 1) The chief executive officer of the company divulges information about its acquisition to a friend who has a high stakes in the company before the information goes public.
- 2) Any government employee gets information about some crucial new economic regulation which may impact some sort of industry does making with securities or stock price dip.
- 3) Any high-level employee after eavesdropping on a high profile meeting about the merger of a company buys shares in the name of his father or some other family member.<sup>10</sup>

<sup>6</sup> Ibid.

<sup>7</sup> Insider Trading Policy 2013. Accessed on April 3, 2023. [https://www.sec.gov/Archives/edgar/data/25743/000138713113000737/ex14\\_02.htm](https://www.sec.gov/Archives/edgar/data/25743/000138713113000737/ex14_02.htm)

<sup>8</sup> US Securities and Exchange Commission. Accessed on March 28, 2023. <https://www.sec.gov/rules/2003/03/disclosure-required-sections-406-and-407-sarbanes-oxley-act-2002>

<sup>9</sup> Bettis, Carr, John Bizjak, and Swaminathan Kalpathy. 2015. “Why Do Insiders Hedge Their Ownership? An Empirical Examination.” *Financial Management*. 44.3. 655-683. p. 658.

<sup>10</sup> What is Insider Trading? Accessed on

### History of Insider Trading in India:

In the year 1990, the president of the BSE commented “There is no other kind of trading in India except the insider variety.” Contrary to this, a strong counter statement by Mr. Adam Lewitt of the SEC was issued in 1998, stating “Insider trading has utterly no place in any fair minded law abiding economy”<sup>11</sup>

“India's first encounter with insider trading became apparent in the 1940s with the release of the Thomas committee report in 1948. The report revealed instances of directors, auditors, and other high-ranking officials having access to confidential information about a company's financial and economic condition. This information included details about upcoming bonuses, dividend amounts, and significant deals or acquisitions that could significantly impact the prices of securities.”<sup>12</sup>

As a result sections 307 and 308 were included in the companies act, 1956. Section 307 stipulated the sustantation of a register by companies to record the directors' shareholdings in the company. Section 308 includes the responsibility of the directors and other higher executives to make a full- fledged disclosure of their shareholdings in the company which could serve as important

information for potential investors. In 1960, the companies act was amended and it extended the disclosure of the information to the companies' managers as well. Notwithstanding all the provisions, the prevalence of insider trading continued to grow at an exponential rate. The absence of specificity in the rules and regulations in

May 2, 2023.

<https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/what-is-insider-trading/>

<sup>11</sup> Desai, Nishith. *Insider Trading Regulations – A Primer*. Accessed on May 23, 2023. [http://www.nishithdesai.com/fileadmin/user\\_upload/pdfs/Research%20Papers/Insider\\_Trading\\_Regulations\\_-\\_A\\_Primer.pdf](http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Insider_Trading_Regulations_-_A_Primer.pdf).

<sup>12</sup> Thomas, P J. Report on the Regulation of the Stock Exchanges in India – 1948., at paragraph 63 of Chapter VI titled ‘The Indian Security Market as It Is’. Accessed on May 23, 2023. <http://www.sebi.gov.in/History/HistoryReport1948.pdf/>.

the Thomas committee report acted as an impediment.

Next in line was the Sachar committee report of 1979 which mentions that the directors, the deemed directors, Auditors Company secretaries and others had rice and set an information that could be used to manipulate stocks which was causing economic Disasters to the common public Which Was investing in the company recommended amendments to the companies act of 1956 to decrease the details of the employees. The committee stated that sections 307 and 308 of the companies act were scant in curbing insider-trading. As per Patel Committee Insider Trading was defined as “Trading in the shares of a company by the person who is in the management of the company or are close to them on the basis of undisclosed price sensitive information regarding the working of the company, which they possess but which is not available to others.”<sup>13</sup>

“SEBI has made changes in how it chooses to define an insider under the regulation 2(e) in 2008 vide the SEBI prohibition of insider trading (Amendment) regulation, 2008. In the present statue, Regulation 2(e) of SEBI ([Prohibition of] insider trading) Regulations, 1992 has defined a<sup>5</sup>n insider as:

{1} is or was connected with the company or is deemed to have been connected with the company and is reasonably expected to have access to unpublished price sensitive information in respect of securities of a company, or,

{2} has received or has had access to such unpublished price sensitive information”<sup>14</sup>

### **Indian and International Cases of Insider Trading<sup>15</sup>:**

#### **Dilip Pendse:**

Dilip Pendse served as the Managing Director of

Nishkalpa, a subsidiary firm of Tata Finance LTD. On March 31st, 2001, the firm Nishkalpa had a significant financial loss amounting to 79.37 crores, which posed a serious threat to the company. The dissemination of this information was scheduled to occur on April 30th. Dilip Pendse illicitly disclosed confidential information to his spouse. Furthermore, this information was highly sensitive to changes in price, as any leakage may result in a significant decline in the stock price. During the period from March 31st to April 30th, a total of 90,000 shares, owned by both his wife and a firm co-managed by his wife and her father-in-law, were sold in Nishkalpa in order to avoid incurring losses.

So, Mr. Pendse, his wife and her father-in-law were found guilty of insider trading and charged a penalty of Rs. 5,00,000. And Mr. Pendse was banned from capital market for a three-year term.<sup>16</sup>

#### **Martha Stewart:**

She was a bigwig in the television industry who had even won Emmys for her show ‘Martha and Snoop’s dinner party’. In and around the year 2001, she owned around 4000 shares of the biopharma company ImClone. The brokerage firm that handled her portfolio had been tipped off about the fact that the CEO of the company had done away with all of his holdings in the company. The CEO had access to insider information that one of the company’s anti-cancer drugs was about to be rejected. Shortly after this, the company’s shares dropped by almost 16%. Martha Stewart, acting upon the information, prevented losses worth USD 45,676. Martha Stewart and the broker were found guilty as the sale of the stake was made based on the fact that the CEO had unloaded all of his shares which was non-public material info. She was given a term of 5 months in a federal correctional facility and fined 30k USD. The chief executive officer of the company was held guilty of insider trading as well and fined USD 4.7 million and was given a jail term of 7 years.

<sup>13</sup> Das, Sonakshi and Sanjana Sahu. 2015. “The Know-All of Insider Trading – Decades of Corruptive Prevention” Accessed on January 20, 2023.

<https://www.lawctopus.com/academike/know-insider-trading->

[decades-corruptive-prevention/](#)

<sup>14</sup> Ibid.

<sup>15</sup> Insider Trading Cases in India. Accessed on June 20, 2023.

<https://tradebrains.in/tag/famous-insider-trading-cases- in-india/>

### **Rakesh Jhunjhunwala:**

Rakesh Jhunjhunwala has been consistently involved in numerous controversies pertaining to insider trading. In 2018, he was questioned on charges of engaging in insider trading with regards to the stocks of the company "Geometric". He resolved the matter by obtaining a consent order from SEBI after paying a nominal charge. In January 2020, SEBI conducted an investigation into him about the accusations of insider trading. He was interrogated on the trading of shares in the IT education company APTECH. APTECH is the only company in Jhunjhunwala's whole portfolio over which he exercises managerial authority and powers. His family members, including his wife and mother-in-law, were also interrogated in addition to him.

### **Foster Winans:**

Foster Winans was an extremely talented Wall Street reporter who wrote columns in the newspaper. Due to the high degree of influence of the WSJ, the stocks that he opined about in his columns fluctuated according to the tone of the columns. He was a columnist at the journal with all the right contacts. The trouble is that he made all the wrong moves. Winans started leaking the contents of his columns to influential personalities in exchange for a share of the profit.

Winans in an interview with Corporate Crime Reporter "One day, I met a stockbroker, Peter Brant, and was going to write an article about him. After a few months, that kind of fell beside the wayside. He one day said to me — that column you write is very powerful, it moves stocks, you are doing a great job, how much do they pay you, isn't it terrible, only \$25,000 a year, with all of the skill and

talent that you have, if you told me what you were going to write about the day before it is published, we'd make a lot of money."<sup>17</sup>

Winans accepted Peter Brant's deal and was later caught within a span of 3-4 months by the SEC for

involvement in 24 rigged trades. He was convicted of insider trading and sentenced to a term of 18 months. The sentence was later reduced.

### **Deontology:**

Deontology is a word derived from the Greek words 'Deon' meaning duty and 'Science' meaning study of (LOGOS). Deontology is a sort of a normative theory which deals in theories regarding choices which may or may not be morally correct. It helps us to guide and assess our choices of what we should do, Deontologists, or those who prescribe to deontological theories have views which contradict those of the consequentialists.<sup>18</sup>

Deontological theories can be broadly categorised under agent-centred vs victim-centred or patient centred theories given by scheffler in 1988 and Kamm in 2007.

According to agent centred theories and views, it is implied that our main goals and what we have intended to achieve most critically showcases our agency. If our intentions are not noble or are even intended for some sort of misfortune, we have set ourselves on a path to evil and wrongdoings, something that is frowned upon by deontologists.<sup>19</sup>

Patient centred deontological theories are based on rights of an individual rather than duty. Some theories are even purportedly said to be agent neutral.

Deontological theories are best understood in contrast to consequentialism ones. Consequentialists state that the acts or intentions should be judged and their morality should be solely based on their result or end product. On the contrary, Deontology believes in performing actions which are moral and abide by your moral compass. It states that the end product should not be taken into consideration, for the end product is bound to be moral if the procedure or incentives taken to achieve it are.

<sup>16</sup> Later, he committed suicide in July 2017.  
[https://timesofindia.indiatimes.com/business/india-business/what-former-tata-finance-md-dilip-pendse-said-in-his-](https://timesofindia.indiatimes.com/business/india-business/what-former-tata-finance-md-dilip-pendse-said-in-his-suicide-letter/articleshow/59471232.cms)

[suicide-letter/articleshow/59471232.cms](https://timesofindia.indiatimes.com/business/india-business/what-former-tata-finance-md-dilip-pendse-said-in-his-suicide-letter/articleshow/59471232.cms)

One of the most popular examples of consequentialist theory is that of the fat man and the transplant. If we imagine we have a healthy person whose organs after being harvested would help save the lives of 6 people. Under moral norms dictated by the consequentialist's theory, the healthy man would be killed by the surgeon and his organs be harvested to save the lives of the other 6 patients. As the end product leads to 6 people getting saved, this action becomes moral according to consequentialist theory. On the other hand Deontology theory does not permit the killing of the<sup>7</sup>

healthy man to save the 6 patients for it focuses not the morality of the process rather than the end result.

In the second case of the trolley, we see a trolley advancing towards a cliff. The only way to impede its motion is to throw a fat man in its path. The trolley has seven passengers on board. According to deontology, as the sacrifice of one fat man would lead to us saving the trolley as well as the passengers on board, it would be perfectly moral to perform the action. But on the contrary, as the procedure of saving the trolley and its passengers leads to the death of the fat man, it is not permissible according to deontology.

### **Kantian View:**

According to Kant, some actions such as murder, theft and lying are absolutely immoral, unethical and strictly prohibited even under the circumstance that the end product would result in something good or some happiness. These views are opposed to that of Mill. The believers in Kant's philosophy should be certain of two facts. First being that everyone would follow what they say and the second being the question that whether their actions are meant for their own selfish needs or the common good. If the answer to any of the questions is no, then the action is not supposed to be performed. Kant's theory is a

form of deontological theory. It is Independent of the end result and totally judges the ethics of the actions by the procedure being followed or the incentives being undertaken.<sup>20</sup>

Kant believed in the existence of a transcendent moral principle known as the categorical imperative. It determines our moral duties and obligations.

Kant regarded morality with utmost gravity and advocated for its universal adherence, irrespective of one's views or absence thereof. He was aware that seeking moral guidance from our faith would provide inconsistent results. He believed that morality, viewed scientifically, is a nearly unchanging and universally true concept. In other words, regardless of one's religious beliefs or geographic location, the fact that two plus two equals four remains constant. He made a distinction between actions driven by morality and those motivated by nonmoral, less honourable reasons. He highlighted that in most cases, our actions are not primarily driven by moral considerations, but rather by our personal desires. If you aspire to be the top student in your class, it is imperative that you dedicate yourself to studying. Without the motivation to succeed, studying would be futile.

Kant viewed morals not in terms of hypothetical imperatives, but in the term of categorical imperatives. He stated that categorical imperatives are commands you are supposed to follow without paying heed to your hidden desires and temptations. These are moral obligations taken from the context of pure logical reasoning. You don't need any religion to define what moral or immoral is, you can just determine that by using basic human intellect.

Kant gave three formulations of categorical imperatives, of which two are extremely popular. The first formulation states that "you should act only according to that maxim which you can at the same time will that it should become a universal

<sup>17</sup> Corporate Crime Reporter 23(10), June 9, 2003  
<https://www.corporatecrimereporter.com/winansinterview.html>  
Accessed on August 20, 2023.

<sup>18</sup> Deontological Ethics. 2007. Stanford  
Encyclopaedia of Philosophy. Accessed

law without any contradiction". For example you steal an apple from a local grocery store because you were extremely hungry and had left your wallet at home ,for if you go back to fetch that wallet, you would only end up missing your classes. In this situation if you justify stealing by citing you desperate condition, you make it universally ethical to steal.

The second formulation is the formulation of humanity. It states that "to act so that you treat humanity, whether in your own person or in that of another, lies as an end and never as a mere means". This implies that we are not mere objects meant for the use of other people, we are our own ends. "We are rational and autonomous. We have the ability to set our own goals and work toward them. Unlike other things in this world, we are self-governed, able to set our own ends, to make our own free decisions based on our own free rational will."<sup>21</sup>

### **Insider Trading Ethics:**

Any type of trading in the<sup>8</sup> financial market if it is legal then it is not necessary that we can say it's also ethical. Principle of ethics in the financial market is easy to understand, that trader at the time of trading should not have any unfair advantage then its ethical or else it is unethical. When we indulge in any sort of insider trading, we act upon the information received from a reliable source. Even though our ulterior motives are pure, i.e. to prevent the losses of our family and ourselves and sometimes maybe even friends, the process we undertake in order to go through with a trade based on insider info is immoral. This makes it completely unethical according to the theory of deontology. This is because when we act on insider information, we do not consider the losses which the common public would face due to the inaccessible data that we have obtained.

According to Kant's first formulation, insider trading will be unethical. This is because if we accept the fact that we should indulge in insider trading, we accept that everyone across the world

should be able to practice that.<sup>22</sup> Only when the money changes hands and we are no longer the beneficiaries of the information do we realise that insider trading is unethical. Even in accordance with Kant's second formulation, if we indulge in insider trading, we consider the common public as our pawns, whose profits according to our own selfish desires. This makes it highly unethical.

### **Conclusion:**

Insider trading has been prevalent since the conception of the stock markets across the world. Since then, numerous steps have been taken to curb the practice in order to make it a fair playing field for each and every single individual, though we have seen billionaires exploiting wide gaping loopholes in the law to their advantage, and we have seen that the agencies have been more than willing to bend to the will of the creme de la creme of society. Such instances have been more prevalent in India than in any other country in the world, such as the USA's SEC, which has undertaken and adopted stringent measures to ensure that no crime goes unpunished. We inspected the deontological and Kantian theories of ethics and realised that insider trading was not only illegal but also unethical. We know this because in instances of insider trading, we see the topmost strata of society profiting at the expense of those who lie in the middle. This makes it an unfailing playing level, which should never be the case. Nevertheless, as time progresses, we hope to see stringent regulations to ensure that the stock market game becomes a level playing field for all and not just <sup>9</sup>a tool for the rich to become richer at the behest of the middle class and the poor.

<sup>20</sup> Kantian Ethics. Accessed on May 28, 2023. <https://corporatefinanceinstitute.com/resources/esg/kantian-ethics/>

<sup>21</sup> Treating Persons as Means. 2019. Accessed on June 3, 2023. <https://plato.stanford.edu/entries/persons-means/>

<sup>22</sup> Lawson, G.S. 1988. The Ethics of Insider Trading. Harvard Journal of Law and Public Policy.11.3. pp. 727-783.