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Not So Watertight: the Scope of "Insider"—Under the Insider Trading Laws in India

Siddesh Biyani[1],*, Shreya Saraiya[2]
[1,2]Student, National Law University Odisha, Cuttack, Odisha, India

Abstract

The article analyses the definition of "Insider" under the SEBI (Prohibition of Insider Trading) Regulations, 2015 ("Regulation"). An attempt has been made to scrutinize the elements determining Insider under the Regulation. The current regime, describing the scope of Insider, is not watertight thus leaving a room for ambiguity and also excludes certain essential determinants which would otherwise be considered as Insiders. The article evaluates the definition of "Connected Person" to determine that the "Outsiders", who may have access to such inside information of a corporation and trade on that basis, have been excluded from the ambit of Insider. The article shows how other countries have realized the mandate of including "Outsider" for the purpose of prohibiting Insider Trading. In furtherance, the article also breaks down the definition of Unpublished Price Sensitive Information ("UPSI") which is contended to have been narrowly defined. The definition pays no heed to the "Outside Generated Information", which may have an impact on the price of securities of the corporation. Moreover, the novel concept of Generally Available Information ("GAI") has been relied more upon for the purpose of defining of UPSI. The concept of "Non Discriminatory Basis" has been used to define GAI. The drafters purposefully avoided laying down what constitutes "Non-Discriminatory Basis" with the object of preventing the narrowed down interpretation of GAI. The article contends that such avoidance would lead to a dubious situation and constrained interpretation of GAI. The article makes a comparative study of the Insider Trading laws in the other countries with that of India's, examining and suggesting the approach adopted, which is more stringent, leaving a negligible scope of interpretation.

Keywords: *Insider, SEBI, Connected Person, Trade, UPSI, GAI, Trading Laws*

****Author for Correspondence*** E-mail: siddeshbiyani11@gmail.com

INTRODUCTION

The U.S. was the first country to realize the negative impact that Insider Trading leaves on the Economy. There had been an intense economic, social and legal debate as to "what constitutes unfair advantage and what is fair reward for the diligent pursuit of the knowledge that aids investment decision [1]." Economists have had different viewpoints on Insider Trading; some have argued that it improves the efficiency of market's pricing [2] while others have stood for fairness and confidence of the investors against overall market growth attained by allocating benefits [3]. As far as the investing community is concerned, it had developed a strong belief that Insider Trading is unfair. [4]

The very realization, by the investor community, of the need to regulate insider trading establishes the intention behind the prohibition of Insider Trading, which is to create a condition of perfect competition and ensuring information symmetry. With the increase in the ability to access the information in this era of technological advancement and rising complexities associated with the product of securities market [5], it has become a mandate for the Security Market Regulators to have a vigorous and watertight legal framework in place.

The P.J. Thomas Committee [6] in India was established in 1948 with the aim of evaluating rejections that can be imposed on the short swing profits. [7] However, the SEBI crystallized the law on Insider Trading by passing the Prohibition of Insider Trading Regulation, 1992. [8] With time and need there were subsequent amendments to the Regulation. The "Sodhi Committee" [9] was established in 2013 under the chairmanship of

Justice N.K. Sodhi with the aim to regularize the then existing Insider Trading regime in India. Based on the recommendations of the Committee Report, the SEBI (Prohibition of Insider Trading) Regulations, 2015 were enacted. [10]

The 2015 Regulations have made an affirmative attempt to improve the Insider Trading Law in India by introducing concepts like Generally Available Information [11] and expanding the scope of the existing notions. However, there exist certain loopholes which defeat the established intention behind the codification of Law on Insider Trading.

POSITION OF "OUTSIDERS" UNDER THE INDIAN INSIDER TRADING LAW

The SEBI (Prohibition of Insider Trading) Regulations of 2015 defines "Insider" as one who is: [12]

a. Connected Person and possesses Unpublished Price Sensitive Information (UPSI) or,
b. Any other person who is in possession or has access to UPSI.

The Regulations further define UPSI [13] and Connected Persons [14] for structuring the definition of the Insider. The ambit of the definitions has been broadened by the recommendation of the N.K. Sodhi Committee Report of 2013. [15] However, the adopted definitions are not watertight and exclude certain essentials which can defeat the purpose of the Act.

Limited Scope of Connected Persons

The definition of "Connected Person" under 2015 Regulations depicts a constrained ambit of persons, who on being in possession of UPSI, will become Insiders. It excludes certain persons who may not be directly related to the company but may have access to certain market sensitive information, which may unfairly be used to exploit the market.

The definition excludes Government officials, policymakers, bureaucrats and judges from its ambit. These persons may have access to such information which may materially affect the securities of the subject company, directly or indirectly, or may affect the market as a whole. For example, a policymaker, aware of the foreign exchange policy coming up in India, may invest in or divest from any security in the market and thereby, gaining unfairly over other market players. The Sodhi Committee, in their Report, had initially recommended for the inclusion of such persons in the definition of "Connected Persons. [16]"

In support to the recommendation, the Committee illustrated that a judge, who may have information of the outcome of the pending litigation, which upon being adjudicated may materially affect the price of the securities of the concerned company [17] or a policymaker, who may have knowledge of the policies regarding the allotment of natural resources, which will eventually affect the prices of the securities, may trade in the securities. [18]

However, the current Regulations have dropped such recommendation and left behind a loophole. [19] Moreover, there is possibility of a third person, who is not a Government official, to have an unauthorized access to such information which may affect the market and securities, and such person cannot be considered as a connected person under the current regime. [20]

The requirement of bringing Government officials and other such individuals under the scrutiny for prohibition of insider trading has been felt across the globe. Many states have adopted regulatory frameworks or are backed by judicial pronouncements for bringing individuals possessing any information, such as sovereign or economic policies, under the ambit of insider trading regime.

Position on an International Front

The Insider Trading laws in USA have evolved over the time. In the case of Chiarella v. United States [21], the US Supreme Court adopted the "Classical Theory" approach wherein, the Court stressed on the "fiduciary or other similar relation of trust and confidence between" [22] the alleged insider and the company. The Court in this case held that only Corporate Insiders [23], who owe a fiduciary duty towards the company, can be held liable for insider trading.

The US Supreme Court emphasized on the concept of "constructive insiders" in the case of Dirks v. SEC. [24] The Court, in this case, extended the ambit laid down in the Chiarella case, and included individuals who "become fiduciaries" to the corporation because "they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes" [25] such as lawyers and accountants. In the instant case, the elements of "trust and confidence [26]" toward the corporation's shareholders were laid down by the Court. However, the US insider trading law was only confined to the individuals who had some direct relation with the corporation [27].

After the case of United States v. O'Hagan, [28] the Insider Trading arrangement took a sharp turn from just focusing on 'fiduciary duty' obligation towards issuer's shareholders to the source of the material nonpublic information used in the securities transactions as well. The case laid down the "Misappropriation Theory," which is premised "on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." [29] The Misappropriation Theory, as laid down by the Court in this case, confers that any individual, who may be an outsider, on having access to such material nonpublic information about a corporation, develops a relationship with the corporation and the source of information wherein, he has to maintain the level of trust and confidentiality entrusted upon him. He is under a duty not to trade, or misuses such information in any other manner.

With the Misappropriation Theory in force, the US Judiciary felt a scope of getting Government Officials under the scrutiny for Insider Trading. In the case of United States v. ReBrook [30], the liability of the Government employee was accrued under misappropriation theory by the District Court. The employee was an attorney of the West Virginia State Lottery; he had an anticipated knowledge of the candidature of the specific manufacturer for a contract of $ 25 Million, which he had developed from misappropriated information concerning the implementation of state wide video game by the Lottery. Misusing the information, he traded in the securities of the Lottery Machine Manufacturer. [31]

In the instant case, it was held that the relationship which existed between an attorney and the lottery department was that of a fiduciary nature. The relationship entails the duty based on three parameters; the state ethics Act of US [32], the inherent responsibilities as a state employee [33] and the relationship of confidentiality he had with his employer. The Supreme Court upheld the district Court's decision and endorsed the misappropriation doctrine.

Although now the US Courts had the scope of holding the Government officials liable for Insider Trading, the law stood on an ambiguous position due to the lack of statutory codification of the same. The Government employees could be scrutinized under other existing legislations which made them responsible for their positions however; they could not be covered within the ambit of insider trading laws. The Chief Justice in the case of Chiarella, stated that proposed American Law Institute Federal Securities Code's antifraud provisions would make the Government official or any other person holding such capacity, would be liable for insider trading. [34]

The prevailing loophole in the insider trading regime for Government officials [35] in the US, which made it "perfectly legal to profit from information obtained within the Congress," [36] led the U.S. Representatives to introduce the Stop Trading on Congressional Knowledge Act (STOCK Act) in 2006. The Act was proposed with the object to "prohibit members and employees of Congress from profiting from non- public information they obtained in their official positions." [37]

The Misappropriation Doctrine has also been adopted in other jurisdictions like U.K., Australia and Hong Kong [38] wherein, the jurisdictions have adopted broad interpretations of Insider Trading Laws not entailing fiduciary duty aspect to creep in for establishing the liability of outsiders.

Likewise, the Securities Law of Jordon has defined insider as anyone who exploits share market by the virtue of price sensitive information obtained due to his position or job, this definition includes Government Officials and other such individuals. [39] The Spanish Securities Market Act is also broad enough to entail Government Officials under its garb to prohibit Insider Trading. [40]

Limited Scope of Information

The rationale behind not including the public servants and the statutory workers was that the Regulations aimed to cover 'insiders' for the purpose of justifying the title of the Regulations. The drafters failed considerably to notice that such exclusion can attack the main object of the Regulation of ensuring fair and just market for all investors.

On the other hand, the definition of UPSI, supported by illustrations, leaves a narrow scope of interpretation. A literal interpretation of the definition implies that the information generated from outside the company, which may materially affect the prices of the securities of the subject company on being published, is excluded. The focus of the Regulation remains on the information which is not generally available and which is generated, directly or indirectly, from inside the company.

The SEBI (Prohibition of Insider Trading) Regulations, 2015 have defined UPSI as any information which is related to "a company" or its securities, directly or indirectly, and which upon becoming "generally available" [41] would materially affect the prices of such securities of the company. [42] The Regulation has been followed by certain guiding illustrations upon which the information must be based. [43] Following are the illustrations mentioned:

"(i) financial results; (ii) dividends; (iii) change in capital structure; (iv) mergers, de-mergers, acquisitions, delisting, disposals and expansion of business and such other transactions; (v) changes in key managerial personnel; and (vi) material events in accordance with the listing agreement."

Classification of Information

In terms of source, material information can be classified into two categories: [44] (1) Corporate Information and (2) Market Information

Corporate Information is such information which comes from within the corporation or which affects the price of securities as a reflection of expected earnings or assets of corporation. [45] Market Information is such information which includes transactions concerning securities of corporation that may cast an impact on the future price of securities as distinguished from changes expected in the corporation's earnings and assets. [46] Information which relates to events or circumstances affecting the market for company's securities having no impact on company's assets or earning power is known as market information. [47]

Market Information relates to the market forces on a general basis [48] for instance, a Federal Reserve Policy change or a "bullish" sentiment among traders. [49] Market information may or may not come from "inside" the enterprise [50] and thereby, can be classified as Insider Market Information and Outsider Market information. [51]

Outside Generated Information and UPSI

An attempt has been made to expand the scope of the UPSI under the new regime. However, the definition is not broad enough to include any "outside" price- sensitive generated information within its fold. The scope of Regulation has been broadened by including the phrase "not restricted to" before laying down illustrations, however, the line of thought to interpret UPSI cannot be deviated from. The recommendation made under the Sodhi Committee Report states that the illustrations are the "Brightline test" [52] for the determination of the UPSI [53]. Further, in the case of Rakesh Agarwal v. SEBI, it was enumerated that any information, to be regarded as UPSI must be in line with the specific matters highlighted in the instant Regulations [54].

Furthermore, the definition focuses more upon the new concept of "Generally Available

Information" [55] of the company rather than broadening the scope of UPSI to include outside market information within its ambit, which may cast an impact upon the price of securities of the subject company.

For instance, information about the Government policy which may affect the functioning of the subject company or a competitor company thereby, materially affecting the price of the security of the subject company, would not amount to UPSI. Such information is not ordinarily related, directly or indirectly, to the any of the illustrations [56] in line of which the UPSI should be determined.

Positions on an International Front

United Kingdom

According to the Section 56 of the Criminal Justice Act, 1993, Part V [57] of the U.K., inside information is the information which is related to particular securities or to a particular issuer of securities and not to securities generally or to issuer of securities generally. However, under Section 60(4) of the Act, it has been clarified that any information which is about the company or which may affect the business prospects of the company is to be treated as inside information. [58]

In the book "Principles of Modern Company Law" by Paul L. Davies and Sarah Worthington, an example has been laid down in this regard that an information about Government's Policy with respect to liberalization in the industry in which the subject company previously had the monopoly would be regarded as inside information. [59] Thereby, in the United Kingdom, "Outside Market Information" would fall under the purview of Inside Information for the purpose Insider Trading.

United States of America

Insider Trading in U.S.A legislative regime, is regulated under Section 10b [60] of the Securities Exchange Act, 1934 and SEC Rules 10b-5 [61], wherein the latter focuses specifically on Insider Trading. In the case of Chiarella [62], the SEC contended that there exists a distinction between "insider" information and "market information" in the abovementioned rules.

However, the Court rejected the contention and held that, "it is clear that Section 10(b) and Rule 10b-5, by their terms and by their history make no such distinction [63]." The judicial interpretation of the rule, as made by the U.S.A. Supreme Court, elucidates that the basis of the liability is not the source or nature of information instead liability is accrued on the basis of materiality of the information. [64]

Though the judicial interpretation broadened the scope of rule, there is a lack of straight-jacket guidance as to bringing "market" information within its ambit. The introduction of STOCK Act, 2012 [65] indicates an attempt of the U.S.A legislation to fill the loophole by codifying the Government Policy related "market" information as Insider Information.

"GENERALLY AVAILABLE INFORMATION" AND ITS WIDER CONNOTATION

The Sodhi Committee had introduced the concept of Generally Available Information (GAI) making it an essential element for defining UPSI. The Committee defined Generally Available Information [66] as any information which is accessible to the public on a "non- discriminatory" basis; this includes any analysis, research, conclusions and deductions drawn from any GAI as well. The definition has also been adopted in the SEBI (Prohibition of Insider Trading) Regulation, 2015 [67].

The Avoidance to Define "Non-Discriminatory Basis"

The scope of the term "non- discriminatory basis" has not been laid down in Sodhi Committee Report as well as in the 2015 Regulations. However, the Sodhi Committee had discussed certain situations to illustrate the ambit of the term "non- discriminatory basis" which in a way broadens purview of the term. The Committee restrained from defining non-discriminatory basis so as to avoid narrowing down the scope. Further, the Committee suggested that it would be ascertained according to the question of fact to be answered as per the standards of reasonable man criteria. [68]

On the other hand, the 2015 Regulations while explaining the term GAI states that any information which is published on the stock exchange would *ordinarily* be regarded as information available on non-discriminatory basis, thereby, narrowing down the ambit of the term by setting higher standards. These standards are not in line with the illustrations discussed in the Sodhi Committee Report.

One such illustration deals with the situation where a CEO of an MNC collapses with a heart attack in a doctor's clinic, would such information in the hands of the public present there be regarded as UPSI or GAI? The Committee came to the conclusion that this information would be regarded as GAI. On the other hand, if the CEO would have collapsed inside the Board room during a meeting, then such information would be regarded as UPSI. [69]

The Committee's avoidance to define 'non-discriminatory basis' with the apprehension of a narrowed down interpretation, negatively led to an adoption of the narrowly laid down standard in the 2015 Regulations. The Committee could have attempted to recommend a standardised definition, incorporating certain tests for the determination of 'non-discriminatory basis' as has been adopted by legal systems like that of Australia.

Positions on an International Front

United States of America

In United States, the SEC has restrained itself from laying down guidelines for the determination of 'Generally Available Information'. However, several approaches have been adopted by the Judiciary considering certain factors like absorption period, specificity, coverage and clarity, for the determination of GAI. Broadly, there exist two approaches to determine if the information is generally available. [70]

Under the first approach, information becomes generally available if it is sufficiently accessible to the concerned investment community. [71] Under the second approach, information becomes generally available if it is disseminated to and absorbed by the investment community. [72] Factors like scope of coverage, clarity of exposure and specificity are to be taken into consideration while ascertaining the dissemination and absorption approach. [73]

Under the dissemination and absorption approach, the publication of information is not an essential requirement. However, the SEC, in the case of *In Re Faberege, Inc*. [74], while determining the dissemination of GAI opined that, "the information must be disseminated in a manner calculated to reach the market in general by means of recognised sources of distribution." [75] In the instant case, the SEC, with respect to the absorption of GAI stated that, "a reasonable waiting period must be dictated by the surrounding circumstances [relating to] the form of dissemination and the complexity of the information, i.e., whether it is 'readily translatable into investment Action.'" [76]

However, the instant approach is subject to factors varying on case to case basis. One such factor is the absorption period of the information. In the case, S.E.C. v. In Goldsby [77], the Court observed two-fold rationale to determine whether the information was fully absorbed. First, the Court studied the price and the volume of the traded stock in question and second, the media and the public exposure of the company which was small in this case.

The SEC, in this direction had proposed the Regulation FD (Fair Disclosure) which was adopted in August 2000. [78] The Regulation FD attempts to channelize public disclosure of material non-public information when the issuer wants to disclose information intentionally. Further, it attempts to regularise the public disclosure of material non-public information which has been discovered to have been selectively disclosed on an unintentional basis. [79]

The Efficient Market Theory focuses on the reach of information to the concerned investment community for the purpose determining GAI and not on the means through which the information has been transmitted. The price of the security would be reflected by the accessibility of the information by a substantial portion of concerned traders and would restrict the insiders from gaining unfairly. [80]

United Kingdom
The U.K. legislation defined the concept of 'inside information' in the Section 118C of Financial Services and Markets Abuse Act, 2000. [81] Accordingly, the definition is based on it being 'not generally available' to the public rather than 'not being made public'. The Financial Services Authority (FSA) Code enumerates certain factors to be kept under consideration for determining GAI. [82] The 'access test' [83] is applied for determining whether the information is published or not, according to which, information is treated as published when it is accessible to the public. However, the drawback of the test is that the information may be of a nature which can only be accessible by the people having the requisite time, money and resource.

Europe
In the Europe, the Market Abuse Directive (MAD) [84] deals with the Insider trading regime wherein, there is no clarification as to when the information would cease to be inside information, whether on the release or on the absorption by the investors. According to the Article 2(1) of the EC Directive [85], the member states are required to ensure that the inside information is made public by the issuer "in a manner which enables fast access and complete, correct and timely assessment of information by public". However, the extent of reach of such information has not been laid down in the said Directive, i.e. whether the information should reach to a large chunk of population or to a section of public. [86]

Australia
In the forerunner Australian Corporate Laws regulating Insider Trading, the term "not-generally available" was defined which led to a lot of uncertainty. However, the current regime of Corporate Law in Australia has defined the term "Generally Available Information" under Sec. 1042C. [87] The definition relies upon two tests for ascertaining whether information would be considered as GAI or not.

The "Readily Observable" Test is the first means adopted to demonstrate if information is GAI. It was included in the legislation after several concerns as to whether 'directly observable information' in public should or should not be treated as GAI arose. [88] However, there had been certain issues regarding the test. For instance, what are the means by which the information will be readily observable? [89]

The second approach adopted under the Australian Law is the "Publishable Information Test." [90] This test is similar to the Market Efficiency Test [91] adopted by the U.S. Under this test, any information would be regarded as GAI if it has been disseminated to the investment community in an appropriate manner and it has been absorbed by them. Under this test, both the manner of dissemination and reasonable period of time, are to be taken into consideration. [92].

CONCLUSION

The attempt of the Legislature to improvise the scope of Insider Trading Law is appreciable however; there is a need to take a step further so as to ensure the adaptability of the legislation in accordance with the dynamic securities market regime.

The developed Legal Systems have gone through grey phases to keep the intention of their Insider Trading regime alive, and now have a more regularised law to keep up with their immense Security Market. India should take opportunity of this evolution pattern, to facilitate the growth of the nascent securities market. The research work, with a positive intention, tries to bring up the possible grey areas under the existing yet newly formulated Insider Trading Law in India.

The existing law has avoided the inclusion of "Outsiders" from the scope of insider for the purpose of the Regulations, and has left it for the interpretation of the Courts of law. Such inclusion was also suggested by the N.K. Sodhi Committee. Furthermore, the legislation does not include materially price sensitive information generated from outside the corporation as UPSI. The Regulations have also avoided defining "Non-discriminatory basis" which will certainly narrow down the interpretation of the Generally Available Information.

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