THE REGULATION OF INSIDER TRADING IN SOUTH AFRICA: A ROADMAP FOR AN EFFECTIVE, COMPETITIVE AND ADEQUATE REGULATORY STATUTORY FRAMEWORK

BY

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DECLARATION.

I, Howard Chitimira, do hereby declare that except for references specifically indicated as such in the text, and any other help as I have acknowledged, this dissertation is wholly a product of my own research, opinions, analysis and industry and has not been submitted in fulfilment of the requirements for degree purposes or for academic examination towards any qualification at any University.

09/01/2008

Alice

To My Parents and My Lovely Sister

TYMON, DIANA AND VIOLAH

You have been and still are my constant source of inspiration

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ACRONYMS.

SRP	Securities Regulation Panel.
FSB	Financial Services Board.
ITD	Insider Trading Directorate.
JSE	Johannesburg Securities Exchange.
BESA	Bond Exchange of South Africa.
DS	Deutsche Securities.
DMA	Directorate for Market Abuse.
ROSC	Report on the Observance of Standards and Codes.
SEC	Securities Exchange Commission.
NYSE	New York Stock Exchange.
NASD	National Association of Securities Dealers.
MSRB	Municipal Securities Rule Making Board.
OSA	Ontario Securities Act.
CBCA	Canada Business Corporations Act.
CCA	Canada Corporations Act.
OBCA	Ontario Business Corporations Act.
CSA	Canadian Securities Administrators.
USL	Uniform Securities Law Project.
ITTF	Insider Trading Task Force.
OSC	Ontario Securities Commission.
IMETS	Integrated Market Enforcement Teams.

SRO	Self Regulatory Organisations.
IMM	Intelligent Market Monitoring System.
CIRI	Canadian Investor Relations Institute.
CSA	Canadian Securities Administrators.
CICA	Canadian Institute of Chartered Accountants.
SEDI	System for Electronic Disclosure by Insiders.
DPP	Director of Public Prosecutions.
ASIC	Australian Securities and Investments Commission.
NSW	New South Wales.
ASX	Australian Stock Exchange.
SOMA	Surveillance of Market Activity.
ACCC	Australian Competition and Consumer Commission.
CAMAC	Corporations and Markets Advisory Committee.
IBSA	International Banks and Securities Association of Australia.
SIASDIA	Securities and Derivatives Industry Association.
SEATS	Stock Exchange Automatic Trading System.
CHESS	Clearing House Electronic Sub-register System.
ASC	Australian Securities Commission.
NCSC	National Companies and Securities Commission.
MOU	Memorandum of Understanding.
CASAC	Companies and Securities Advisory Committee.
CAMAC	Corporations and Markets Advisory Committee.

ABSTRACT.

Insider trading is one of the practices that (directly or indirectly) lead to a host of problems for example inaccurate stock market prices, high inflation, reduced public investor confidence, misrepresentation and non disclosure of material facts relating to securities and financial instruments. Again it reduces efficiency in the affected companies and eventually leads to economic underperformance. The researcher observed that the South African insider trading regulatory framework has some gaps and flaws which need to be adequately addressed to ensure efficient and stable financial markets. Therefore, the aim of this research is to provide a clear roadmap for an effective, efficient, adequate and internationally competitive insider trading regulatory framework in South Africa.

In order to achieve the above stated aim, the historical development of the regulation insider trading is critically analyzed. The effectiveness and adequacy of the Insider Trading Act, 135 of 1998 is also discussed. Furthermore, the prohibition of insider trading under Securities Services Act, 36 of 2004 is explored and analyzed to investigate its adequacy. The role of the Financial Services Board, the Courts and the Directorate for Market Abuse is also scrutinized extensively. Moreover, a comparative analysis is undertaken of the regulation of insider trading in other jurisdictions of United States of America, Canada and Australia. This is done to investigate any lessons that can be learnt or adopted from these jurisdictions. The researcher strongly contends that having the best insider trading laws on paper alone will not cure the insider trading problem. What is required are adequate laws that are enforced effectively in South African courts. Therefore an adequate insider trading regulatory framework must be put in place to improve the efficiency of South African financial markets, to maintain a stable economy, combat misrepresentation and non disclosure of material facts in transactions relating to securities.

The researcher has attempted to state the law as at 31 August 2007.

KEY TERMS AND CONCEPTS.

1. Insider trading.

2. Inside information.

3. Insider.

4. Dealing.

5. Securities.

6. Financial instruments.

7. Tipping.

8. Regulated markets.

9. Non public information.

10. Price-sensitive information.

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CHAPTER ONE

RESEARCH OUTLINE AND CONTEXT.

1. INTRODUCTION AND BACKGROUND OF THE RESEARCH.

1.1. INTRODUCTION.

Insider trading is a practice by which one person armed with price or value sensitive non public (confidential) information, concludes a transaction in securities to which that information relates without sharing that piece of information with others.[1] The controversial insider trading debate dates back to the 1920s when its effect was first felt in the United States of America after a heavy crash occurred in its Stock Markets in 1929.

In 1933 the United States of America became the first country to regulate insider trading, but some scholars still argue that regulating insider trading is economically undesirable in several respects. On the other hand scholars who support the regulation of insider trading agree that regulation is necessary to have accurate and efficient financial markets. They submit further that active enforcement of insider trading legislation helps companies to have a broader market base and aids countries to have viable economies.

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[1] See Osode P C "Defending the Regulation of Insider Trading on Basis of Sound Legal Orthodoxy: The Fiduciary Obligations Theory" in Okpaluba C (ed) *Law in Contemporary South African Society* (2004) New Africa Books 303. The investing and non investing public in most countries have expressed disapproval of the illegal practice of insider trading. In some countries it was seen as a criminal offence committed against the issuer of the affected securities, while in others as a crime against the affected company and investors, as well as a "civil offence" committed against the company or issuer of affected securities and investors. The term "issuer of securities" is used in this dissertation to refer to a company or any other issuer of money market instruments. I do agree with the view that insider trading must be treated as an offence against the issuer of securities *and prejudiced investors*. However the application of the insider trading legislation in South Africa does not adequately protect the investors who purchase or sell shares to their disadvantage because they are ignorant of the relevant inside information.

In South Africa the prohibition of insider trading can be traced back to section 233 of the Companies Act, 61 of 1973 which was later replaced by section 440F of the same Act. All these provisions however turned out to be ineffective and insider trading was allegedly a common practice in South Africa. The South African legislature eventually followed the example of other countries that disapproved of insider trading practices by enacting a separate piece of legislation specifically to deal with the matter.[2] The historical development of the provisions that regulated insider trading will be dealt with in Chapter Two of this dissertation.

The enactment of the Insider Trading Act, 135 of 1998 was a positive indication that the South African authorities and policy makers acknowledged that insider trading undermines public investor confidence, reduces market efficiency, negatively affects a company's performance and in the long run it will adversely affect the economy. The 1998 Act was eventually replaced by the Securities Services Act, 36 of 2004. This research will investigate whether the regulatory framework that was established by the legislation in South Africa can effectively regulate insider trading activity. This will be done in conjunction with an investigation into the problems caused by insider trading activity in South African companies and financial markets. The problem seems to be far from being solved and technological developments such as the electronic buying and selling of securities on Johannesburg Securities Exchange might, if not managed properly, bring more challenges in relation to the detection of insider trading. It is further an open question whether the regulation of insider trading should be restricted to regulated markets. Many legal scholars agree that the insider trading problem will be resolved only if the existing regulatory framework is effectively implemented and enforced by the courts. To examine whether these concerns are valid, the following questions ought to be answered in this research:

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[2] The government and its policy makers must be commended for its efforts to combat insider trading by passing the Insider Trading Act 135 of 1998. Although a number of activities that are related to insider trading were now also prohibited there were gaps and flaws in the 1998 Act. See Osode P C *op cit* note 1 303. Also see the concluding remarks by Osode P C "The New Insider Trading Act: Sound Law Reform or Legislative Overkill?" (2000) 44 *Journal of African Law* 239.

- Is the South African insider trading legislation adequate? If it is not, what can be done to offer a solution to the insider trading problem?
- Is the existing insider trading regulatory framework capable of enhancing investor confidence, and is it effective and internationally competitive? If not, how can its effectiveness be improved?
- Are the companies and the public aware of the problems caused by insider trading? What can be done to educate and increase public awareness in this regard?
- What else, if anything can be done to combat insider trading in South Africa?
- Is the insider trading regulatory framework applicable to all companies, financial instruments and financial markets?

The research will therefore look closely into the adequacy and effectiveness of the existing legal framework, the role of the Financial Services Board (FSB) and its capability to perform its function of initiating prosecutions and civil actions effectively and timeously without interference from other institutions.[3]

The researcher will look comparatively at the regulation of insider trading in other selected countries for the purpose of learning from their experience and bringing the South African legislation in line with the latest developments elsewhere. The discussion in Chapters Five, Six and Seven will focus briefly on the United States of America, Canada and especially Australia respectively.

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[3] The legislation on insider trading in South Africa seems not to have been fully implemented and enforced in our courts. Although a number of investigations were reported to have been conducted by the Financial Services Board and the Insider Trading Directorate (which is now The Directorate for Market Abuse), the mere fact that only a few settlements in civil cases and no criminal convictions have been recorded, confirms that assumption. See http://www.fsb.co.za 13 July 2006.

Identification of flaws in the current regulatory framework[4] without recommending how to correct them would serve no purpose. The research seeks to provide answers to many questions concerning insider trading in South Africa, such as whether the solution lies in enacting new laws or enforcing the existing laws. Is it a matter of amending existing laws or a matter of having adequate and effective laws? Was it a wise move to repeal the Insider Trading Act, 135 of 1998 or was it a legislative blunder? It is hoped that this research will play a significant role in providing guidelines and insight on the way forward.

1.2. BACKGROUND OF THE RESEARCH.

There is an assumption that insider trading is a common practice in South Africa and that unscrupulous directors, managers and others use non public price-sensitive information on a large scale at the expense of those who do not have access to such information. Insider trading was treated as mere fraud against shareholders rather than the issuer of securities and it was regulated accordingly.[5]

When it eventually transpired that the provisions that were embodied in the Companies Act, 61 of 1973 were not adequate to regulate insider trading, a committee chaired by Mr Mervin King was appointed to investigate and recommend appropriate ways of regulating insider trading in South Africa.[6] The King Report recommended a new Act to deal specifically with the regulation of insider trading in South Africa. The Insider

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4 The term "regulatory framework" is used interchangeably to refer to the insider trading regulatory framework and also the insider trading legislation.

5 See Stephan Malherbe and Nick Segal "2001 draft for OECD" on http://www.google.com 11 January 2006. The shareholder–manager conflict was therefore worsened by the failure of the legislature to enact an adequate and effective insider trading regulatory framework. Also see Commission of Enquiry into the Companies Act Main Report 15 April 1970 85-88. Previously insider trading provisions were only applicable to directors, officers and employees of companies to the exclusion of others like "tippees" who can also benefit from it.

6 The report of this commission will be referred to as the King Report.

Trading Act, 135 of 1998 was enacted and came into force on 17 January 1999.[7] An analysis of the effectiveness of this Act as well as an analysis of its successor, the Securities Services Act, 36 of 2004 is necessary to investigate whether it was desirable to consolidate into one Act, other legislation that previously dealt with securities and financial instruments as well.[8]

1.3. THE REGULATION-DEREGULATION DEBATE.

Insider trading practices are often reported in the press and news reports in many developed countries where adequate laws were put in place to regulate it and which are also effectively enforced. This does not necessarily happen in developing countries like South Africa.

The United States of America, after the 1929 collapse of its stock markets, became the first country to enact laws against insider trading.[9] The subject of insider trading has attracted so many controversies that some financial analysts and academics actually argue that the regulation of insider trading is both undesirable and unnecessary. The

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7 See Cilliers H S and Benade M L *Corporate Law* 3rd ed Butterworths Durban 2000 149-150; Myburgh A and Davis B "Commentary on the impact of Insider Trading Act" http://www.google.com 03 October 2006. Although the Insider Trading Act 135 of 1998 arguably managed to convince most directors and managers that insider trading is undesirable for their companies' efficiency and ability to receive a broader market base from both domestic and foreign investors, many companies were reluctant to comply with its provisions.

8 The Securities Services Act 36 of 2004 came into force on 1 February 2005 and also repealed the Stock Exchange Control Act 1 of 1985 (SECA), the Financial Markets Control Act 55 of 1989 (FMCA), the Custody and Administration of Securities Act 85 of 1992 and the Insider Trading Act 135 of 1998. Amendments were made to the Companies Act 61 of 1973, the Financial Services Board Act 97 of 1990 and the Insolvency Act 24 of 1936. Also see Osode P C *op cit* note 2 239.

9 In reaction to the Congress's mandate to protect investors and to keep the markets free from fraud, the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted to combat insider trading abuses which were believed to have contributed to the 1929 crash of stock markets. See generally "The regulation of insider trading in United States of America" http://www.sec.gov 02 March 2006; Georgakopoulos N L, Bainbridge S M and Dooley M P "How insider trading should be regulated" http://www.genesisanlytics.com 02 March 2006.

proponents for insider trading regulation, on the other hand, allude to the fact that the regulation of insider trading is vital for efficient, accurate and internationally competitive financial markets and that insider trading activity should not be tolerated. The question of whether or not it is desirable to regulate insider trading however, remains unanswered.

The basis of the arguments *in favour of insider trading regulation* can be summarized as follows:

- Insider trading reduces public investor confidence and must be regulated properly to protect all the investors. This argument is based on the assumption that insiders who trade in securities or financial instruments at the expense of other outside investors hamper the company's potential to attract more investors.
- Insider trading worsens the manager-shareholder conflict and results in increased agency costs. This is called the *agency theory of insider trading*, which is supported by Jensen and Meckling[10] and also Georgakopoulos.[11] They argue that insider trading which benefits the company or shareholders is legitimate but if it results in an illegal benefit of control that accrues to the managers at the shareholder's expense it will raise the agency costs.[12]

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[10] See Jensen M C and Meckling W H "Commentary on how insider trading increases agency costs or expenses" http://www.genesisanalytics.com 02 March 2006.

[11] See Georgakopoulos N L, Bainbridge S M and Dooley M P *op cit* note 9 on "How insider trading should be regulated". Also see Georgakopoulos N L "Insider Trading as a Transaction Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation" (1993) 26 *Connecticut Law Review* 34-69.

[12] Jensen M C and Meckling W H "The agency theory of insider trading" define agency costs as the expenses incurred by a company that hires the services of stock brokers and financial analysts in an attempt to enhance its efficiency. They further submit that regulating insider trading reduces conflict of interest between shareholders and managers. Hence it helps to avoid any prejudice to the shareholders concerned. The agency theory focuses on the impact of insider trading by corporate insiders on a company's level of efficiency and corporate value. Also see generally http://www.genesisanalytics.com 02 March 2006.

- Bainbridge[13] submits that insider trading amounts to theft of a company or corporation's property and must be controlled to reduce and avoid the consequences it may have for companies and financial markets. Prohibiting insider trading is the best means of property protection and is important for any company to remain competitive and efficient. This view is supported by Dooley[14] who states that illegal disclosure of confidential information by an insider to any other person is an offence against the company to which that person owes the fiduciary duty to refrain from self-dealing in confidential information. The proprietory rights in relation to its confidential information accrue to the company which should have in place an internal insider trading regulatory framework that prohibits insiders and others from selectively dealing with it at the company's expense.

- In terms of the *market theories*, the proponents for insider trading regulation argue that regulation of insider trading will improve the accuracy and efficiency of financial markets, and that combating insider trading reduces the risk of manipulation of stock prices by insiders or even high inflation rates in affected countries. Regulation will further allow company managers to trade in securities in the best interests of their companies which may cause stock prices to be more stable and more accurately reflect the actual value of securities and financial instruments.

- Kraakman[15] submits that a market characterized by a high level of insider trading may be less liquid and recommends that all companies have their own self-regulatory mechanisms. If the information asymmetry is extreme, uninformed investors may refrain from trading altogether and therefore there is a need for countries to have good insider trading laws which are effectively enforced.

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[13] See Georgakopoulos N L, Bainbridge S M and Dooley M P *op cit* note 9 on "How insider trading should be regulated". Also see Bainbridge S M "The Insider Trading Prohibition: A Legal and Economic Enigma" (1986) 38 *University of Florida Law Review* 35.

[14] See Dooley M P "Enforcement of Insider Trading Restrictions" (1980) 66 *Virginia Law Review* 1-89.

[15] See Kraakman R H "The Legal Theory of Insider Trading Regulation in the United States" in Hopt K and Wymeersch E (eds) *European Insider Dealing* Butterworths London 39-54.

- Earlier scholars focus mainly on the morality of insider trading, that is whether it is fair or unfair to innocent investors. They argue that insider trading must be regulated because it is unfair to outside investors and it reduces public investor confidence.[16] However this approach does not take into account that it is not only investors who are affected by insider trading. It lacks a rigorous theoretical framework and fails to generate useful legal and policy prescriptions for insider trading regulation.

- Coming to South Africa, insider trading is now treated as both a civil wrong and a criminal offence, but this research will reveal that legislation in South Africa did not remove illicit insider trading practices from the South African financial markets. Although the Insider Trading Act, 135 of 1998 had some impact in reducing insider trading practices, it still had its weaknesses[17] which were not addressed in the Securities Services Act, 36 of 2004 where the same flaws were largely repeated. Therefore there is still a need for a more adequate, effective and internationally competitive insider trading regulatory framework in South Africa.

Those who *oppose the regulation* of insider trading, on the other hand, argue that regulation is undesirable and unnecessary and actually reduces financial market efficiency. They submit that for companies and financial markets to be efficient, valuable information about securities should not be disclosed to everyone. Regulating insider trading might further result in serious prejudice to employees who ignorantly and innocently disclose inside information to other persons if these persons would later trade in securities on the basis of this information.

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[16] See Scotland R A "Unsafe at any Price: A Reply to Manne" (1967) 53 *Virginia Law Review* 1425-1478.

[17] See Osode P C *op cit* note 2 239 who argues that the 1998 Act did not provide for a mandatory disclosure mechanism for all instances of insider trading, nor did it give a right of action to issuers and only looked at deterrence as the best way to stop insider trading. Hence it was inadequate and ineffective. Also see Davidson S "Insider trading: A reply to Brian Kantor" (1991) 21(3) *Businessman's Law*, who submitted that prohibiting insider trading is not the only way to guarantee market efficiency and that increased disclosure requirements would lead to even greater efficiency. It is therefore plausible to properly regulate insider trading, rather than to endure its effects.

Proponents of deregulation also state that insider trading reduces the conflict between shareholders and managers, and consequently agency costs. It is therefore unreasonable to regulate it. Manne,[18] and Calton and Fischel[19] allude to the fact that strict insider trading regulation may have a chilling effect on the work of securities analysts and therefore inhibit sensible dialogue between company officials and securities analysts. They submit that stringent insider trading laws must be removed so that securities analysts can do their analytical research without any fear of contravening a prohibition on disclosure of price-sensitive information.

Proponents of deregulation further argue that insider trading is an efficient disclosure mechanism that is less costly than the traditional means of disclosure. However it is difficult to understand how insider trading can be an efficient disclosure mechanism because the trading often takes place before publication of the information. Manne[20] argues that because insider trading is based on the use of non public information, it will whenever it occurs, cause prices to adjust and to reflect the value of the securities more accurately.

Coming to the South African scenario, proponents for deregulation also argue that regulating insider trading will lead to inefficient markets. This is the so-called *efficient market hypothesis* (EMH), which means that relevant information must play a part in the determination of share prices and that the time between the production of information

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[18] Manne H G "*Insider trading and the stock market*" (1966a) *New York* 189ff. Also see Elder L "Legalize insider trading" http://www.capmag.com 05 May 2005.

[19] Calton and Fischel "The Regulation of insider trading" (1983) 35 *Stanford Law Review* 857-866.

[20] See Manne H G "In Defence of Insider Trading" (1966b) 44 *Harvard Business Review* 113-122; Calton and Fischel *op cit* note 19 857-866. The proponents of the deregulation of insider trading submit that it promotes market efficiency because the persons who possess inside information will not trade in securities or financial instruments without practically disclosing it. Calton and Fischel as well as Manne, argue that the regulation of insider trading will worsen the manager-shareholder conflict. Hence it is both undesirable and unnecessary to regulate it. Furthermore they maintain that insider trading is a victimless offence, hence enforcing insider trading laws discourages corporate investments and is not cost effective.

and its communication to the market will be reduced if insider trading is allowed. The deregulation argument however did not enjoy much support in South Africa. On the contrary, the King Task Group was appointed to investigate the insider trading problem in South Africa and to make recommendations for an adequate and effective insider trading regulatory framework.

1.4. AIMS AND OBJECTIVES.

1.4.1. Aim.

The aim of this research is to provide a clear roadmap for an effective, efficient, adequate and internationally competitive insider trading regulatory framework for South Africa and the enforcement thereof, to eliminate or at least reduce as far as possible, insider trading activities. This may enhance efficiency and stability in our financial markets, increase investor confidence and may possibly contribute to the solution of problems such as inaccurate stock market prices, high inflation, misrepresentation or non disclosure of material facts relating to securities and financial instruments and economic underperformance generally.

1.4.2. Objectives.

For the purposes of this dissertation, the researcher has the following specific objectives:

a) To recommend structures that will ensure more effective implementation and enforcement of insider trading laws in South Africa.

b) To recommend additional appropriate sanctions and penalties for illicit insider trading, that can be imposed on all offenders but without, at the same time, affecting anything done in good faith for the benefit of the company or in the normal course of a person's duties.

c) To recommend methods and measures to ensure that potential perpetrators are aware of insider trading offences and that victims are *adequately* aware of the remedies that are available to them.

d) To recommend amendments to the Securities Services Act, 36 of 2004 to ensure that its provisions are applicable to all financial instruments and financial markets.

e) To encourage South African financial markets and individual companies to have their own internal insider trading regulatory frameworks.

1.5. ASSUMPTIONS UNDERLYING THE STUDY.

For the purposes of this research a number of assumptions have to be made in relation to matters that cannot be easily verified. The assumptions can be summarized as follows:

a) Insider trading is a controversial issue and there is a wide-spread assumption that it occurs on a large scale in financial markets, that it reduces investor confidence and eventually cripples the economy of any country due to inefficient and unenforceable insider trading laws. It is contended that South Africa has good legislation on insider trading but that it is not properly implemented and enforced. The fact that many companies are being investigated by the Financial Services Board through the Directorate for Market Abuse is not necessarily an indication of a rigorous implementation of insider trading laws but rather that insider trading is in spite of that, still a problem in South Africa, because of the paucity of settlements and convictions.[21]

b) If insider trading occurs on a large scale in a country it is likely to undermine investor confidence and the efficiency of financial markets which in turn may have an adverse effect on the economy. The weaknesses in the South African insider trading legislation therefore need to be addressed.[22]

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[21] See http://www.fsb.co.za 13 June 2005. Various companies have been investigated and some are still being investigated for insider trading violations but very few convictions in criminal cases and settlements in civil cases have been achieved to date.

[22] A greater degree of transparency on the part of companies may have the effect of attracting more investors. Illegal insider trading practices will on the other hand discourage investors.

c) Clear and adequate insider trading legislation will also attract foreign investments to a country, make such a country more competitive in relation to attracting foreign investors and give companies in such a country a broader financial investment base. Section 2 of the Securities Services Act, 36 of 2004 actually gives recognition to this assumption and states that the main aim of the Act is to increase public investor confidence in South African financial markets by ensuring that all securities services are provided in a fair, efficient and transparent manner.

1.6. STATEMENT OF PROBLEM AND HYPOTHESES.

1.6.1. Statement of problem.

Because insider trading activity is a serious problem and is assumed to be a common practice in South Africa, the flaws and ambiguities in our insider trading legislation need to be addressed. The absence of convictions and successful civil claims suggests that many persons may escape liability or delays may occur in their prosecution if the enforcement of insider trading legislation is ineffective[23] which in turn may cause prejudice to affected persons and issuers of securities. The following specifically identified problems need to be addressed:

a) The South African insider trading regulatory framework seems to be based on the premise that the only way to combat illegal insider trading is through deterrence. Its focus is on severe penalties for offenders and the availability of a civil remedy to aggrieved persons. These methods have not been effective. Further reform and alternative sanctions and remedies are needed.

b) The implementation and enforcement of insider trading laws in South Africa needs urgent redress.

c) More effective education and awareness strategies have to be employed to ensure that companies and members of the public are aware of the insider

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[23] See Crotty A "First Insider Trading Case goes to Court" *Business Report* 19 October 2001 *Sunday Times* 26 January 1997 25. Also see Osode P C *op cit* note 1 303.

trading offence and available remedies. Apart from the insider trading manual which was published by the Johannesburg Securities Exchange at the request of the Minister of Finance, no other measures were taken to make the public aware of insider trading activity and its consequences. Companies and other entities should be encouraged to make their own policy guidelines available to staff and management.

d) Insider trading laws have a limited application in South Africa. They only apply to regulated markets and listed securities. Trading in unlisted securities on the basis of inside information is not prohibited. Some scholars argue that in cases of unlisted companies, the transactions are unlikely to be anonymous. The seller and purchaser will be knowing each other fully and the general principles relating to fraud and misrepresentation should apply. It is however still possible that shareholding through trusts or nominees may hide the identity of an insider and it can be argued that insider trading laws should also apply to unlisted securities. The wide scope of the topic under discussion compels the researcher to concentrate on insider trading activity in relation to listed securities but he is of the opinion that this matter has to be considered in future. In this dissertation however, it will be referred to briefly whenever necessary.

e) Existing insider trading laws and rules do not clearly provide for a right of action to the issuers of securities.[24]

f) Unlike the position in other developed countries such as Canada where offenders are liable to compensate the actual person who was affected by the insider trading transaction, there is also no statutory provision for such an action in South Africa and aggrieved parties may only claim through the

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[24] Some commentators argue that the absence of a right of action to issuers of securities in South African insider trading legislation is a serious mistake that needs urgent redress. See Osode P C *op cit* note 2 239.

FSB. The absence of such a right of action as an alternative to or in lieu of claiming through the FSB is in the opinion of the researcher a disadvantage.

g) The Securities Services Act, 36 of 2004 provides for a number of offences in the form of actual dealing by an insider who is aware that he has inside information, or by encouraging others to deal or discouraging others from dealing, or simply by disclosing the inside information to others. The maximum sentence for all these offences is the same. While this is a very positive move in trying to combat insider trading the researcher observes that this may be unfair to insiders who for example made innocent remarks or inadvertently disclosed information to other persons, where they had no intention that such disclosure be acted upon.

h) Weaknesses in an insider trading regulatory framework may not be conducive for companies and financial markets to become internationally competitive. This may, to an extent be overcome by companies having in place internal self regulatory systems to combat insider trading. This in turn may help companies to attract local and foreign investors.

1.6.2. Hypotheses.

For purposes of investigating, examination and solving these problems the following hypotheses were assumed:

(a) Although the policy goal of deterrence which was adopted in South Africa to combat insider trading is very important, it must not be the only strategy. Alternative strategies should be considered.

(b) The onus on the prosecution is severe in criminal cases of insider trading and the inclusion of a rebuttable presumption in relation to matters peculiarly within the knowledge of the accused should be considered. The same applies in civil cases to assist the Directorate for Market Abuse when it takes action or negotiates settlements.

(c) Public awareness and education in relation to insider trading offences should be enhanced and incentives be used to encourage more persons to report incidents of insider trading to the responsible authorities without fear of reprisal.

(d) Legislation should be widely applicable to all securities, irrespective of whether they are listed.

(e) International competitiveness is a key to success of companies in today's global economy and technological environment. Competitiveness should be enhanced in every possible way, to combat insider trading. Companies should therefore have their own internal regulatory frameworks that discourage insider trading.

1.7. RATIONALE FOR THE STUDY.

The impact of insider trading has been felt in many financial markets worldwide and South Africa is no exception. The absence of legislation that can effectively regulate insider trading is the reason for this research, the rationale being the promotion of public investor confidence, awareness of insider trading activity and market efficiency. To achieve this, flaws in the existing legislation and regulatory framework should be identified and their negative impact be minimized. An in depth analysis will be made, of existing legislative provisions, their weaknesses and ambiguities, practices related to insider trading that are not covered, and the reasons why, if any, so little has been done in terms of the enforcement of the Securities Services Act, 36 of 2004. The functions and effectiveness of the FSB, Directorate for Market Abuse (DMA) and the courts will be considered.

1.8. LIMITATION OF THE STUDY.

The research will focus on the statutory provisions regulating insider trading in South Africa and in particular the provisions of the Securities Services Act, 36 of 2004. However legislation in force prior to 2004 will be discussed for the purpose of tracing the historical development of insider trading laws in South Africa and for purposes of

comparative study, referral will be made to insider trading legislation of selected foreign jurisdictions. The study will not discuss all the provisions of the Securities Services Act, 36 of 2004 and the Insider Trading Act, 135 of 1998 but it will be limited to those that are relevant to the topic. Provisions of other South African statutes will only be quoted for purposes of reference and comparison. The internal listing requirements and surveillance mechanisms of the JSE Ltd will not be dealt with in detail due to space and scope restrictions and because this research is restricted to legislation with the exception of the disclosure requirements which will be dealt with briefly in Chapter 4.

1.9. SPECIFIC MATTERS TO BE INVESTIGATED.

a) The researcher will primarily investigate the strengths and weaknesses of the Securities Services Act, 36 of 2004 and its implementation.

b) The repeal of all previous legislation and the consolidation thereof in the Securities Services Act, 36 of 2004 and whether this was move in the right direction will be considered briefly.

c) An investigation into the powers of and the authority given to the Financial Services Board and the Directorate for Market Abuse is essential to evaluate the effectiveness of the enforcement of insider trading laws in South Africa.

1.10. RESEARCH METHODOLOGY.

For purposes of addressing the problems as highlighted and making appropriate recommendations for an effective insider trading regulatory framework in South Africa, the following research methods will be used:

(a) Internet browsing.

The researcher will refer to relevant websites for information. This is important and convenient because it gives the researcher access to the

opinions of various commentators and authors. The dates referred to, ***are the dates on which the websites were accessed by the researcher***.

(b) Library.

A number of libraries will be visited to access relevant books, case law, journals, statutes and other relevant materials.

(c) Case law and court decisions.

An examination and analysis of relevant case law and judicial precedents will be conducted.

(d) The study of relevant legislation and statutes.

This research will focus on the Securities Services Act, 36 of 2004 and Insider Trading Act, 135 of 1998. Other relevant statutes from South Africa and other selected countries will be referred to for purposes of historical and comparative analysis.

(e) Historical analysis.

This method will be employed in Chapters Two and Three of this dissertation. The main objective is to investigate the evolution of insider trading legislation in South Africa and to compare it with the current provisions.

(f) Comparative research method.

The researcher will employ comparative studies between South African insider trading laws and those of selected countries that may have more effective regulatory frameworks in place, to learn from their experiences and for purposes of possible application in South Africa.

2. STRUCTURE OF THE DISSERTATION.

This dissertation has eight Chapters, including this Chapter.

Chapter One deals with the general study context. It outlines the aims, objectives, statement of problem, assumptions underlying the research, rationale of the study, specific matters to be investigated and the research methodology.

Chapter Two discusses the historical development of the regulation of insider trading in South Africa prior to 1998. This Chapter investigates the regulation of insider trading in terms of the Companies Acts of 1926 and of 1973 as amended, their impact, effectiveness and adequacy.

Chapter Three examines the adequacy and effectiveness of the provisions of the Insider Trading Act, 135 of 1998, including a critical analysis of the meaning and interpretation of the concept of insider trading, the adequacy of the proscribed penalties, defences and of the civil and criminal sanctions in terms of that Act.

Chapter Four investigates the adequacy and effectiveness of the prohibition of insider trading under the Security Services Act, 36 of 2004. This Chapter further discusses whether or not the current regulatory framework has successfully fulfilled its objectives, which are purportedly aimed at reducing systemic risk, protecting regulated persons and increasing public investor confidence in the South African financial markets.

Chapter Five provides a comparative perspective of the regulation of insider trading in United States of America and South Africa, for purposes of examining whether the integration of some of the US insider trading principles into the South African regulatory framework has worsened or improved the regulation of insider trading in South Africa.

Chapter Six provides a comparative analysis of the regulation of insider trading in Canada and South Africa and investigates whether our legislature should not also have taken note of some developments in Canada.

Chapter Seven gives an incisive comparative analysis of the regulation of insider trading in Australia and South Africa. Drawing from the successful track record of the Australian regulatory framework it must be investigated whether principles of Australian law can be recommended for consideration in South Africa.

Chapter Eight discusses some guidelines, conclusions and recommendations to solve the insider trading problem in South Africa.

It is important to note that for purposes of this dissertation the researcher uses the masculine to refer also to the feminine.

CHAPTER TWO

HISTORICAL DEVELOPMENT OF THE REGULATION OF INSIDER TRADING IN SOUTH AFRICA PRIOR TO 1998.

2.1. INTRODUCTION.

The controversial subject of insider trading has been a topical issue in many countries.[1] South Africa is no exception. It is a generally accepted fact that the problems caused by insider trading were also found in South African financial markets and companies as early as the beginning of the twentieth century. Insider trading was not treated as a statutory offence in South Africa until 1973.[2] Prior to that, it was only required that certain particulars about shareholding of directors be recorded by the company.[3] The move towards a prohibition on and the regulation of insider trading in South Africa was orchestrated by the Van Wyk de Vries Commission of Inquiry into the Companies Act of 1973. The Commission acknowledged that insider trading was a malpractice.[4]

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1 See http://www.sec.gov 23 March 2006. The unresolved conflict between the proponents for the regulation of insider trading and those who oppose its regulation is a clear indication of a great cloud of confusion and controversy that revolves around the subject of insider trading - see the discussion in Chapter one.

2 The regulation of insider trading in South Africa only dates back to the enactment of the Companies Act 61 of 1973. Section 233 of this Act was the pioneering provision which contained a prohibition on insider trading. This was after the adoption by the legislature of the various recommendations made by the Van Wyk de Vries Commission of Inquiry into the Companies Act in its Main Report.

3 See paragraph 2.2.1.

4 For purposes of this dissertation the Commission is hereinafter referred to as the "Van Wyk de Vries Commission" and its main report as "Van Wyk de Vries Report". See Van Wyk de Vries Report paragraph 44.57. The Van Wyk de Vries Commission treated insider trading as a malpractice and a difficult problem that called for legislative intervention to combat its negative effects. See Van Wyk de Vries Report paragraph 44.49 and the reservations of Arthur Suzman in his minority report (hereinafter Suzman reservations) paragraph 8.1. Also see generally Osode P C "The Regulation of Insider Trading in South Africa: A Public Choice Perspective" (1999) 11 *African Journal of International and Comparative Law* 688; Meskin P M (ed) *Henochsberg on the Companies Act* 4th ed Butterworths Durban 1985 367.

The insider trading prohibition in section 233, however, turned out to be inadequate and ineffective for purposes of combating insider trading, because for almost twenty years after its inception, no person was successfully prosecuted under this section.[5] This resulted in the subsequent enactment by the legislature of section 440F as introduced in terms of the Companies Amendment Act, 78 of 1989 and later replaced in terms of the Second Companies Amendment Act, 69 of 1990. These Acts raised more questions than they were able to answer. They *inter alia* provided for a very limited definition of insider trading. This and other flaws, forced the legislature back to the drawing board.

In September 1995, the Reserve Bank's Policy Board for Financial Services and Regulation on the request of the Ministry of Finance appointed "The King Task Group into the Insider Trading Legislation"[6] to investigate the insider trading problem in all South African financial markets. The King Task Group recommended the enactment of a separate piece of legislation that would help to curb the insider trading problem. The Insider Trading Act, 135 of 1998 was enacted following the adoption by the legislature of the final King Report. However, this Act again failed to provide a solution to the insider trading problem.[7]

Because of various flaws found in the Insider Trading Act, 135 of 1998, it was repealed and replaced by the Securities Services Act, 36 of 2004.[8] The New Act like its predecessors has its own flaws. This reflects that the current South African legislation

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5 The first case against persons who dealt in securities on basis of unpublished price-sensitive information in South Africa was brought to court in September 2001. See Crotty A "First Insider Trading Case goes to Court" *Business Report* 19 October 2001; Cokayne R "Setback for South Africa's first insider trading case" *Business Report* 28 April 2004.

6 Hereinafter referred to as "The King Task Group" and its report as "The King Report". The King Task Group recommended a wider application of the insider trading prohibition to all persons who practised insider trading, also on the derivative, equity and bond markets. See *King Report* paragraph 3.3.1.

7 See Chapter 3. The Insider Trading Act 135 of 1998 was heavily criticized by many scholars in that it simply existed on paper but very little was achieved in terms of enforcement of its provisions in the courts. See also Cokayne R *supra* note 5.

8 Hereinafter referred to as the "New Act".

on insider trading is still inadequate and ineffective. This Chapter will deal with insider trading legislation prior to 1998. The 1998 and 2004 Acts will be comprehensively dealt with in Chapters 3 and 4 respectively.

2.2. THE REGULATION OF INSIDER TRADING PRIOR TO 1998.

The discussion that follows will firstly deal briefly with the legal position prior to 1973, and the conclusions and recommendations of the Van Wyk de Vries Commission. This will be followed by a brief discussion of the initial provisions of the Companies Act dealing with insider trading as were found in sections 229-233. It is however not intended to discuss all these provisions in detail. The focus will be on the prohibition in section 233, followed by a critical analysis of section 440F.

2.2.1. The law prior to 1973.

In spite of the perception that insider trading activity was already common in South African financial markets since the early 1920s, there was no legislation that regulated insider trading.[9] Many role players on the financial markets were probably ignorant of its existence and negative consequences. Insider trading can be regarded as fraud on the part of an insider and in theory the normal remedies for fraud or misrepresentation are available, on the basis that there is involuntary reliance on the full disclosure of price-sensitive inside information.[10]

In the case of listed shares, however, the parties are usually anonymous which would make it easier to practise insider trading and to thrive at the expense of other persons who were not privy to the non public price-sensitive information in question.[11] As a result of this, it can be concluded that the South African financial markets were a haven for those

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[9] See Loubser R "Insider Trading" http://www.jse.co.za 12 October 2006. Also see Meskin P M *op cit* note 4 367; Van Wyk de Vries Report paragraphs 14.51-54 and Suzman reservations paragraphs 8.01-8.15.

[10] See *Pretorius and another v Natal South Sea Investment Trust* 1965 (3) SA 410 (W) 417.

[11] See the authorities quoted in note 9.

who practised insider trading and that this perception deterred both local and foreign investors.[12]

Although the authorities gradually realized the negative consequences of insider trading, the initial effort to curb it was unsuccessful. Section 70*nov* (11) of the Companies Act, 46 of 1926 indirectly dealt with certain issues that relate to insider trading but without noticeable success.[13] It provided for directors but not other potential insiders, to report to the company, particulars about their shareholdings for them to be recorded. The purpose of these requirements was *inter alia* to discourage insider trading by ensuring transparency as far as directors's interests in the company and transactions in relation to directors's shareholdings were concerned. Insider trading was not prohibited, and there was no definition of insider trading, or what constituted inside information. The provisions only applied to shares or debentures held by directors or in trust for directors or to which a director had any right to become the holder at the commencement of section 70*nov*(11). The section did not apply to other potential insiders such as company officers, managers, employees or others having access to non public information by virtue of their positions in the company or relationship with the company.[14] It must

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[12] On an investment field trip to San Francisco, Chris Gilmour a South African investment research analyst got to know how the world perceived the South African financial markets in 1997. He was not surprised when he heard a fellow investment analyst from America narrating the other side of the South African financial markets when she said that "the Johannesburg Stock Exchange is characterized by poor liquidity and insider trading". *Prima facie* this summarizes how ineffective and inadequate the regulation of insider trading in South Africa was. This caused some persons to be sceptic and to avoid investing in South African financial markets and companies. It is also against this background that the government later adopted the recommendations from the King Task Group and enacted a separate piece of legislation to curb insider trading in an attempt to restore public investor confidence in South African financial markets. See Gilmour C "Surveillance exchange shows its cleaner face" http://www.free.financial mail.co.za 16 May 2006.

[13] See discussion on sections 229-233 of the Companies Act 61 of 1973 in Meskin P M *op cit* note 4 365-372.

[14] See Meskin *supra* note 13. Also see Van Wyk de Vries Report paragraphs 44.49; 44.55; 44.62.

therefore be accepted that insider trading remained a malpractice in South African financial markets that discouraged investment and caused prejudice to the economy.[15]

2.2.2. The Van Wyk de Vries Commission Report.

The Van Wyk de Vries Commission found that:

- insider trading is a malpractice that should be condemned in all its forms;[16]
- insider trading activity is not only practised by directors, but also by officers, employees or other persons;[17]
- insider trading takes place in South Africa although its extent is difficult to determine.[18]

It also found that insider trading is not limited to listed shares but also extends to other interests in a company and unlisted securities.[19] In relation to unlisted securities, however, the Commission concluded that the identity of the parties is usually known and legislative intervention would not be necessary. Although a director (as an insider) does not owe fiduciary duties to individual shareholders,[20] any person who has inside

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[15] As a result of inadequate insider trading legislation and enforcement thereof, it was generally accepted that the South African financial markets lost considerable amounts of capital investment because insider trading activity discouraged both local and the foreign investment. See Christo E and Sibanda G "Foreign direct investment into South Africa" http://www.fsb.coza 11 September 2006. Also see Luiz S M "Insider Trading: A Transplant to cure a Chronic Illness?" (1990) 2 *SA Merc LJ* 59.

[16] See Van Wyk de Vries Report paragraph 44.49.

[17] See Van Wyk de Vries Report paragraphs 44.49; 44.50.

[18] See Van Wyk de Vries Report paragraph 44.54.

[19] See Van Wyk de Vries Report paragraph 44.49.

[20] This would mean that where shareholders would sell their shares to directors ignorantly, such directors would not be obliged to compensate them because they owe no fiduciary duty to disclose any price-sensitive information in relation to shares to the shareholders. This view found support in *Percival v Wright* [1902] 2 Ch 421, where it was held that directors owe no fiduciary duties to individual shareholders. This could mean that ignorant shareholders would not find any recourse from the directors who practised insider trading which could potentially lead to a shareholder-manager conflict.

information, however owes a positive duty of disclosure on the basis of involuntary reliance on the part of the other party on such disclosure.[21]

In relation to listed securities, however, the Commission found that different considerations apply because these transactions are anonymous and it was confirmed that, at that time, it was impossible for the JSE to identify the parties involved.[22] It was further found that the company is unlikely to be prejudiced by insider trading activity, except perhaps where the share price decreases while the company is in the process of raising capital. The parties who are truly prejudiced are the buyers or sellers who as outsiders, do not have access to the non public price-sensitive information and would not receive any meaningful protection if the perpetrators were to pay a penalty to the company.[23] It was concluded further that a civil remedy would not be feasible, but that insider trading in respect of listed shares should be made an *offence* with a substantial penalty.[24] Suzman, a member of the Commission, made a minority recommendation that the underlying transaction should be voidable.[25] The majority report[26] did not, however exclude the possibility of a prejudiced purchaser or seller instituting a civil action against a perpetrator in terms of common law.

It was found in addition, that *timeous disclosure* of inside information by the company to its members should play a role in curbing insider trading. Interim reporting should make a useful contribution as well as an extension of the provisions of section 70*nov* (11) to cover a wider range of particulars that should be disclosed.[27] It was recommended further, that the strengthening and extension of JSE disclosure requirements should be

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21 See *Pretorius and another v Natal South Sea Investment Trust supra* note 10; Van Wyk de Vries Report paragraphs 44.51-44.53.

22 See Van Wyk de Vries Report paragraphs 44.54; 44.59.

23 See Van Wyk de Vries Report paragraph 44.50.

24 See Van Wyk de Vries Report paragraphs 44.57; 44.59-60.

25 See Suzman reservations paragraph 8-26.

26 See Van Wyk de Vries Report paragraph 44.60.

27 See Van Wyk de Vries Report paragraphs 44.55; 44.56; 44.61. This includes full disclosure of shares and other securities dealings, dates and prices. Evidence of unjustifiable withholding of inside information was however noted.

encouraged.[28] Companies should be required to nominate persons other than directors who by virtue of their positions, have access to inside information, to update the list of particulars that are required on a regular basis and to ensure that this information is available for public inspection.[29]

Ultimately it was noted that directors and other insiders should not be precluded from dealing in securities indefinitely, simply because they have access to general information about their companies. The prohibition on insider trading should therefore be limited to dealing on the basis of non public price-sensitive inside information.[30]

2.2.3. The regulation of insider trading in the Companies Act, 61 of 1973.

Various authors allude to the fact that the regulation of insider trading only commenced with the enactment of sections 229-233 of the Companies Act, 61 of 1973.[31] The provisions in these sections will be briefly outlined with the emphasis on a critical discussion of section 233.[32] These sections were included in the Companies Act, 61 of 1973[33] in accordance with the recommendations of the Van Wyk de Vries Commission.[34]

Section 229 of the Act contained a number of definitions for purposes of sections 230 to 233. The term "interest" *included* any right to subscribe for, or any right to any shares or debentures or any option in respect of shares or debentures, *without derogating* from the generality of the word. The term "officer" included any employee who would be in possession of any information consequent to his immediate relationship with the directors immediately before public announcement of information under section 233.

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28 See Van Wyk de Vries Report paragraph 44.56.

29 See Van Wyk de Vries Report paragraph 44.62.

30 See Van Wyk de Vries Report paragraphs 44.58; 44.62.

31 See Jooste R "Insider Trading: A new clamp-down" (1991) 20 *BML* 248 and the *Explanatory Memorandum to the Objects of the Companies Second Amendment Bill of 1990* B 119-90 (GA).

32 An analysis of all the provisions of the Act is beyond the scope of this dissertation.

33 The Companies Act 61 of 1973 is hereinafter referred to as the "Act".

34 See the summary of the Van Wyk de Vries Report in paragraph 2.2.2 above.

It should be noted that the use of the phrase "includes" suggests that these definitions are not exhaustive. The term "interest" may for instance also cover the interest of beneficiaries under a trust to receive dividends or which a trustee, executor or guardian might have had in those capacities, in a company's shares. Likewise, the term "officer" was wider than the definition in section 1 in the sense that it could include other employees who did not occupy executive positions.[35] The definitions of "past director" and "person" respectively had the effect of extending the provisions of sections 230 to 233, to persons according to whose instructions directors would normally act and to past directors for a period of six months after they had ceased to be directors. "Shares and debentures of the company" included shares and debentures of companies in the same group.

These definitions later turned out to be inadequate because insider trading activity is not restricted to shares or debentures or similar interests in a company and persons other than directors, officers or others connected to the company may also be involved.

Section 230 proscribed the particulars that were to be supplied to the company. They were the number of and amount paid for shares or debentures held, nature of any material interests, as well as in chronological order, the date of each entry and any changes therein. Public companies having a share capital had to enter these particulars into a register within seven days after receipt thereof.[36] This register had to be available for inspection and the Registrar was entitled by written notice, to require the company to furnish him with any relevant particulars.[37] Failure to comply with any of the provisions of these sections was a criminal offence.[38] Section 230 applied only to public companies having a share capital. Although sections 231 and 232 referred in general terms and without any qualification to directors and other employees of "a company", it seemed as

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[35] As suggested in the earlier editions of *Henochsberg on the Companies Act*. See for instance Milne A, Nathan C, Lamont Smith K and Meskin P M *Henochsberg on the Companies Act* 3rd ed Butterworths Durban 1975 404-405.

[36] See section 230(1).

[37] See section 230(2) and (3).

[38] See sections 230(4); 231(2); 232(3).

if the intention of the legislature was that these sections should apply only to public companies having a share capital as well.

Section 232 required directors, as soon as they acquired knowledge of the non public inside information, to determine forthwith by resolution, the names of officers taken to be in possession of that information. These persons then had to inform the company forthwith and by written notice, of the particulars as was provided for in section 230(a) and (b) and this obligation would cease, only on public announcement of the information concerned.[39] Directors and others according to whose instructions, the directors were accustomed to act, had to lodge with the company, a written notice containing the same information within a month of becoming a director or becoming entitled to give instructions to any director, as well as of any changes in the relevant particulars.[40]

Section 233 provided that every director, past director, officer or any person who had knowledge of inside information concerning a transaction or proposed transaction or the affairs of the company, which, if it would become publicly known, could be expected to materially affect the price of the shares or debentures, shall be guilty of an offence if he would deal in any way to his advantage, directly or indirectly in such shares or debentures before public announcement of such information on a stock exchange or in a newspaper or through medium of the radio or television. This section specifically prohibited insider trading in listed shares.[41]

A glance at the relevant provisions of the Act might easily tempt one to conclude that significant progress was made towards the eradication of insider trading in South Africa. However this is not the case and various flaws can be identified in these provisions.

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[39] See section 232 (1) (d) and (2).

[40] See section 232 (1) (b) and (c) read with section 230 (2). See also subsection (1) (a) that provides for particulars regarding non public inside information at the time the Act came into operation

[41] The term insider trading was only used in relation to shares listed on a regulated market (JSE). The legislature ignored the fact that it applied to the whole area of sale and purchase of shares whether on a regulated or on unregulated market. There was no clear definition of insider trading and it also applied only to directors or officers of a company. Other persons like tippees who could also practise insider trading were not included. See Loubser R *supra* note 9 and Jooste R *op cit* note 31 248.

Firstly, the prohibition in terms of section 233 only covered insider trading by *primary insiders* such as directors, former directors and employees of a company. It did not cover other persons who could be involved in *secondary insider trading* activities such as tippers and tippees. An insider who encouraged or discouraged others from dealing in securities could therefore not incur any liability under section 233. The other person who received the tip or who was encouraged or discouraged could not incur any liability either, if he dealt in securities on the basis of such information, unless he also happened to be a *primary insider* or a person "on whose instructions the directors were accustomed to act". Others who were not directly or indirectly involved in the management or who were not employees of a company, such as attorneys or financial advisors were also not precluded from taking advantage of using inside information which they, from time to time could be expected to have.[42]

Furthermore, in the absence of a comprehensive definition of "price-sensitive information", section 233 could be interpreted as referring only to information that related to the internal affairs of the company itself or of other companies of the same group. The prohibition would not apply where directors of an offeror company in relation to a proposed take-over, had inside information that was likely to have a material effect on the price of securities of the target company which at that stage was not yet a company in the same group as the offeror.[43]

Section 233 on the other hand, had the effect of unjustifiably treating some forms of insider trading as unlawful which perhaps should not be treated as such. For example it covered a transaction conducted by a director or an employee of a company in the best

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[42] See Jooste R "Insider Dealing in South Africa" (1990) 107 *SALJ* 595. Insiders such as directors could for instance easily communicate non public price-sensitive information to a tippee who is not in any way connected to the company and later without being detected share in the benefits from any transaction concluded by the tippee. Also see Loubser R *supra* note 9 and Jooste R *op cit* note 31 248.

[43] Directors of the offeree company could likewise be in a position to take advantage of price-sensitive information in relation to the shares of the offeror.

interests of the company, where it was concluded on the basis of non public price-sensitive information that related to the company's securities or financial instruments.[44]

Secondly, section 233 only applied to listed securities and companies that were listed on a regulated market in South Africa. Although it may be argued that persons who trade in unlisted securities and not on regulated markets should know each other's identity, these securities could have been held by trusts or by nominees on behalf of the beneficial shareholders who could have been insiders. Insider trading activity could therefore occur without being detected and it was in all probability very common in unregulated markets. This was regarded by some commentators as one of the main weaknesses of section 233.[45]

Thirdly, section 233 only applied to securities in entities to which the Act was applicable. This meant that insiders were not prohibited from trading on the basis of price-sensitive inside information relating to entities other than companies such as public sector institutions[46] or financial instruments like gilts and derivatives.

Fourthly, the absence of a clear mandatory disclosure requirement could enhance contravention of section 233. Disclosure by public announcement on a stock exchange or in a newspaper or through medium of radio or television was required.[47] It was therefore possible for directors and officers of a company to publish price-sensitive information in an obscure local newspaper or on a radio programme with a limited listernership or during awkward hours, say very early in the morning or late at night.

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[44] It could be argued that this amounted to over-criminalizing the insider trading offence and it could contribute to a failure by directors and employees to perform their duties properly.

[45] See generally Beningfield P "Insider trading: the net widens" (1992) *DR* 278; Osode P C *op cit* note 4 693-699 and Jooste R "The Regulation of insider trading in South Africa: another attempt" (2000) 117 *SALJ* 284.

[46] Insider trading in government and semi-government bonds could therefore not be prosecuted in terms of section 233.

[47] See section 233.

Although published, such information would not have reached the minds of the persons who were likely to be affected.[48]

Fifthly, insider trading was merely treated as a criminal offence which could be committed by a director, officer or employee of the company or a person in accordance with whose instructions, any director was accustomed to act. In addition to proving that the accused was a person falling under one of these categories, the onus was on the prosecution to prove beyond reasonable doubt that the person accused *was aware of* the fact that the information he possessed was non public confidential information.[49] It is submitted that this may be extremely difficult to prove and could have impeded prosecutions. The penalty of a maximum fine of R2000 or imprisonment for a period not exceeding two years or both,[50] would certainly not be sufficient to deter potential offenders, considering the enormous profits that an insider could make from such transactions.[51] No provision was made for directors or other insiders to compensate shareholders, for example if such shareholders had sold their shares to the directors ignorant of the fact that they might suffer prejudice due to insider trading.[52] Provision for civil liability would not only have been an additional deterrent for potential perpetrators, but could also have provided a meaningful remedy to the victims of insider trading activity.

Lastly, it must be remembered that the Van Wyk de Vries Commission found that insider trading affects the relationships between insiders and the purchasers or sellers of shares, as the case may be and accepted that it would not result in any prejudice to the company

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48 However those involved could escape liability on basis that they had published the price-sensitive information relating to the affected securities to the public. See Jooste R *op cit* note 31 248.

49 See section 233.

50 See section 441(1)(b).

51 See generally Botha D "Control of Insider Trading in South Africa: A Comparative Analysis (1991) *SA Merc LJ* 1.

52 Directors do not owe any common law fiduciary duties to individual shareholders - see *Percival v Wright supra* note 20 421; but see remarks regarding involuntary reliance on information at the disposal of the other party in paragraph 2.2.2 above; *Pretorius and another v Natal South Sea Investment Trust supra* note 10 417.

itself.[53] A possible exception could be where the capacity of the company to raise additional capital would be detrimentally affected if the price of its shares on the open market would decrease as a result of insider trading, but the connection between the prejudice and the insider trading activity was considered to be too remote to justify further consideration.[54] This however had the potential of creating a shareholder-manager conflict if directors in terms of a fiduciary duty to the company, were under an obligation not to disclose confidential information to others, but at the same time owed a duty to disclose such information to shareholders or others in terms of section 233. This potential manager-shareholder conflict was not addressed.[55]

It can therefore be concluded that the prohibition in section 233 was ineffective. It failed to deter persons from practising insider trading. In fact not a single person was successfully charged or prosecuted under section 233.[56] Directors and employees of companies enjoyed an unfair advantage over other persons who were denied the opportunity to compete equally in the buying and selling of shares.[57]

2.2.4. The regulation of insider trading in terms of the Companies Amendment Act, 78 of 1989.

Because section 233 failed to solve the insider trading problem, it was repealed and replaced by a new provision in terms of section 6 of the Companies Amendment Act, 78 of 1989. A Chapter that dealt with the regulation of securities was added to the Companies Act.[58] Section 440F formed part of this Chapter and contained a prohibition of insider trading in fairly wide terms. A director, past director or any other person connected with a company who had knowledge of any information which, when published, was likely to affect the price of such securities, would be guilty of an offence

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53 See Van Wyk de Vries Report paragraphs 14.50; 14.51.

54 See Van Wyk de Vries Report paragraph 14.50.

55 See *Companies Second Amendment Bill of 1990* B 119-90 (GA).

56 See Cokayne R *supra* note 5.

57 See generally Botha D "Aspects of capital market efficiency and statutory regulation of insider trading in South Africa" (1991) 15 (2) *Journal for Studies in Economics and Econometrics* 57-69.

58 Chapter XVA "Regulation of Securities".

if he would deal in such securities within 24 hours after the public announcement of that information on a stock exchange, or in a newspaper or television or by other means.[59] Tippees would incur the same liability if they would deal on the basis of the information received from any of the persons referred to in subsection (2)(a), at any time when the tipper was not allowed to deal.[60]

The maximum sentence was substantially increased. Persons who were convicted of insider trading could be liable to pay a fine of R500 000 or to be imprisoned for a period not exceeding 10 years or both. Section 440F in its original form however repeated most of the flaws that were discussed in detail in relation to section 233. It was criticized for having largely adopted American principles on insider trading without proper regard to South African circumstances.[61]

This section never came into operation and will therefore not be discussed in detail. It was replaced by a new section 440F that was introduced in terms of the Second Companies Amendment Act, 69 of 1990.[62]

2.2.5. The regulation of insider trading in terms of the Second Companies Amendment Act, 69 of 1990.

Due to fears that the Companies Amendment Act, 78 of 1989 was inadequate, the Second Companies Amendment Act, 69 of 1990 revised the provisions of section 440F extensively and introduced a number of innovations. This section was expressly made applicable to all dealings in securities. The term "securities" was defined to include company shares as well as stock debentures convertible into shares and any rights or interests in a company or rights or interests in respect of any such shares, stock or debentures including any financial instruments as defined in the Financial Markets

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59 See section 440F(2)(a). However the prohibition did not apply to dealing in member's interests in respect of close corporations.

60 See section 440F(2)(b).

61 See generally Botha D *op cit* note 57 57-69; Osode P C *op cit* note 4 688.

62 The Companies Amendment Act 69 of 1990 is hereinafter referred to as the "1990 Act".

Control Act, 55 of 1989.[63] However the Minister could, on the advice of the Securities Regulation Panel[64] and by notice in the *Government Gazette*, exempt any class of persons from the provisions of section 440F[65] and the section also did not apply to a member's interest in a close corporation.[66]

This definition was still limited to securities in companies or financial instruments as stated. The term "companies" in this context entailed entities registered or recognized in terms of the Companies Act.[67] Insider trading in relation to interests in other entities, including government and semi-government stock was therefore not clearly prohibited.[68]

Section 440F(1) provided that any person who would knowingly deal directly or indirectly in a security on the basis of unpublished price-sensitive information in respect of that security,[69] would be guilty of an offence if he knew that such information had been obtained:

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[63] See the definition of "security" in section 440A(1).

[64] The Securities Regulation Panel (hereinafter referred to as the SRP) was created in terms of section 440B and apart from its functions in relation to take-overs and mergers, it had, in terms of section 440F the responsibility to advise the Minister on exemptions from section 440F. It also had the power to investigate cases of suspected insider trading, to provide a proper forum where complaints of insider trading could be lodged and it was given the responsibility to determine whether to institute civil proceedings or to refer the case in question to the Attorney general's office for prosecution. See the *Memorandum on the Objects of the Companies Amendment Bill 1989* B 99-89 (GA); Botha D *op cit* note 57 57-69.

[65] See section 440F(6).

[66] See section 440F(5).

[67] See the definition of "company" in section 1; also see sections 2 and 3 on application of the Act.

[68] See Luiz S M "Prohibition against trading on inside information – the saga continues" (1990) *SA Merc LJ* 328.

[69] The fact that many types of information other than financial data could *per se* also have a material effect on the price of securities or financial instruments was overlooked. Examples are incompetence of senior directors at the time of their appointment and resignations of company directors. Such information may arguably not fall under the definition of inside information in terms of section 1 but it may still have a material effect on the price of securities or financial instruments if investors would withdraw their investments in the company because of that - see Luiz S M "Prohibition against trading

(a) by virtue of a relationship of trust or any contractual relationship, irrespective of whether or not the person concerned was a party to that relationship; or

(b) through espionage, theft, bribery, fraud, misrepresentation or any other wrongful method, irrespective of the nature thereof.[70]

This clearly prohibited not only insider trading *per se* by a person who knew that the unpublished price-sensitive information had been obtained in one of the ways as stated, but the words "irrespective of whether or not the person concerned was a party to that relationship" suggested that tippees were also prohibited from dealing on the basis of a tip.[71] This can be regarded as an improvement.

"Unpublished price-sensitive information" was defined as information which:

(a) related to matters of internal affairs of a company, or to its operations, assets, earning power or *involvement as offeror or offeree company in an affected transaction*;[72]

(b) which was not generally available to the reasonable investor; and

(c) would reasonably be expected to affect materially, the price of such securities if it were generally available.[73]

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on inside information – the saga continues" (1990) *SA Merc LJ* 328 and Botha D "Control of insider trading in South Africa: a comparative analysis" (1991) 3 *SA Merc LJ* 1.

[70] A relationship of trust can exist, for example between a company and its directors, officers, employees, auditor, attorney or financial advisor, but the legislature seemed to have overlooked the fact that a shareholder who is not a *primary insider* does not stand in a fiduciary relationship with the company although he might have inside information.

[71] See Jooste R *op cit* note 31 248.

[72] The effect of the emphasized words was that directors or other employees of an offeror company in a proposed take-over were now prohibited from dealing in securities of an offeree company until particulars relating to that take-over were published. The same applied to dealings by directors or other employees of the offeree company in relation to securities of the offeror company.

[73] See section 440F (2)(a).

The term "generally available" meant available in the sense that such steps had been taken, and such time had elapsed, that it could reasonably be expected that the information in question should have been known to the reasonable investor in the relevant markets.[74]

It was however stated that it would often be very difficult to establish whether reasonable steps had been taken to bring the information to the attention of the reasonable investor in the relevant markets.[75] An assumption that the information should be known to the reasonable investor in the relevant markets, depended on the steps that had been taken and the time that had elapsed since the taking of those steps, without further mandatory disclosure requirements that could serve as guidelines.[76]

Two rebuttable presumptions were however introduced to assist the prosecution in obtaining a conviction in terms of section 440F(1).[77] Firstly, if it was proved that the accused, at the time of the alleged dealing, was in possession of unpublished price-sensitive information in respect of the relevant securities, it would be deemed, unless the contrary is proved, that the accused had *knowingly dealt* in those securities *on the basis* of such information.[78] Secondly, if proved that the unpublished price-sensitive information was obtained in a manner as stated in section 440F(1)(a) or (b) the accused was deemed to have known that the information had been so obtained, unless the accused could prove the contrary.

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74 See section 440F (2)(b).

75 See Beuthin R C and Luiz S M *Beuthin's Basic Company Law* 2nd ed Butterworths 1992 260. The investor had to assess the situation himself, irrespective of whether the price of the securities would later be affected or not.

76 See the comments on publication in terms of section 233 in paragraph 2.2.3 above, where the question was asked whether publication in a newspaper having insignificant circulation numbers or over an unpopular radio or television channel would suffice. Also see section 140A (3) of the Companies Act as introduced in terms of the Companies Amendment Act 37 of 1999; explanatory remarks on disclosure requirements in *Government Gazette* (18868) 8 May 1998.

77 See section 440F(3).

78 The emphasis is that of the researcher.

The maximum sentence remained a fine of R500 000 or imprisonment for a period of 10 years or both. However, the prosecution of insider trading remained ineffective in that no person was convicted for insider trading in terms of the 1990 Act.[79]

Moreover, any person who contravened section 440F could incur civil liability for any loss or damage suffered by any other person as a result of such a transaction.[80] Where the action for damages related to transactions on a stock exchange or a financial market,[81] the plaintiff was not required to prove malicious intent or negligence on the part of the defendant, or to prove the actual profit made or loss avoided by the defendant.[82] It was *inter alia* the role of the SRP to police insider trading. This entailed the task of monitoring and enforcing the insider trading prohibition. The SRP was given the powers to enforce disclosure requirements by requesting companies to disclose all the details of the amount of equity securities of which a person was a beneficial owner.[83] The SRP was also responsible to ensure that persons who suffer harm due to insider trading have a fair platform to lodge their complaints so that they have proper access to a civil remedy. However, there was no provision for victims to claim compensation directly from persons who were convicted of insider trading or for a claim by the company as the issuer of the securities.[84]

Lastly the 1990 Act still did not cover a situation where insiders acted in the best interests of their companies. Section 440F apparently treated all forms of insider trading as illegal. This created other problems. In spite of the amendments that were brought about by the 1990 Amendment Act, insider trading remained a problematic issue in South

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79 See generally Luiz S M *op cit* note 68 328.

80 See section 440F(4)(a).

81 As defined in section 1 of the Financial Markets Control Act 55 of 1989 (that was repealed).

82 Section 440F(4)(b).

83 See section 440B. Also see section 140A (3) and the remarks in note 75.

84 It was difficult to detect the actual guilty person for example where a tippee traded in securities (indirectly) through a nominee account. This veil of confusion made it very difficult for victims of insider trading to claim any damages from any person who practised insider trading. See Gilmour C *supra* note 12.

Africa and the regulation of insider trading as provided for in the Act and all its amendments remained unsatisfactory.[85]

This was also evidenced by the fact that there was still not a single conviction in a criminal case. It was only in 2001 that the first attempted prosecution for contravening the prohibition on insider trading was reported in South Africa.[86] The case involved Carol Louise Botha (CB) of Waterkloof Agricultural Holdings in Pretoria and Charles Owen Wiggill (CW) who was the managing director of Nissan Manufacturing, a wholly-owned subsidiary of Automakers. Automakers was the holding company of Nissan South Africa. It was alleged that CB made a profit of R947 634 by dealing in 700 000 shares of Automakers on the basis of unpublished price-sensitive information that she obtained from CW. After receiving tips from CW, CB allegedly placed an order with a stock broking firm Smith Borkum Hare on 16 January 1997 to purchase 700 000 Automakers shares at R3 to R3, 50 a share. The order was executed on that same day for a total of R1, 928 million. The price per share ranged between R2, 62 and R2, 86. Automakers only published a cautionary announcement on 17 January 1997 and on 20 January 1997 it released details of a proposed scheme of arrangement, in terms of which Automakers would be delisted and minority shareholders were offered R4, 11 a share. In terms of this scheme, CB was paid R2, 877 million for the shares she had acquired through the alleged insider trading. However, it took five years for CB and CW to be prosecuted because of the inadequacy of the insider trading prohibition in the Act.

2.3. CONCLUDING REMARKS.

The pioneering provisions in the Companies Act, 61 of 1973 (including all its amendments) were not only inadequate and ineffective for purposes of combating insider trading, but by the time the legislature adopted sections 229 to 233 as a first attempt to create an effective insider trading regulatory framework in South Africa, it was long overdue. It was unfortunate that the negative effects of insider trading were only

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[85] See *Hansard* (*Parliamentary Debates*) 24 May 1989 10293-10296.

[86] See Cokayne R *supra* note 5; Crotty A *supra* note 5.

appreciated at this late stage.[87] This allegedly resulted in a loss of investor confidence in South African financial markets and eventually a loss of both local and foreign investors.

As highlighted paragraph 2.1 above, the Reserve Bank's Policy Board for Financial Services and Regulation eventually, at the request of the Ministry of Finance appointed the King Task Group to investigate the insider trading problem in South Africa[88] and to make recommendations for adequate and effective insider trading legislation. The King Task Group published its first draft report on 15 May 1997 and the final report on 21October 1997. Various recommendations were made to reform the regulation of insider trading.

Perhaps, the *most significant* of these recommendations was that the insider trading prohibition should be widely applied to cover all securities or financial instruments in regulated financial markets[89] and not be limited to securities in companies alone. It recommended further that insider trading should not be regulated by the provisions in the Companies Act, but in a separate Act that has a more extensive application. This was widely welcomed by both the government and the investing public.

Liability for insider trading activity was now extended to *secondary insiders* (tippers *and* tippees). Tougher penalties were recommended for insider trading offences. A fine of R2 million or imprisonment for a period not exceeding 10 years or both was recommended. The King Task Group recommended further that provision be made for civil liability, so that persons who suffer loss as a result of insider trading could be compensated. Persons who suffered losses due to insider trading should be allowed to

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87 This submission is based on the assumption that even since the beginning of the previous century, the absence of adequate and effective legislation to combat insider trading allowed many persons to enjoy the benefits thereof without incurring any liability. Also see Gilmour C *supra* note 12.

88 This King Task Group was commissioned by the Minister of Finance in September 1995.

89 The prohibition on insider trading was to apply to all securities (equities, options and futures) and financial instruments listed on regulated markets in South Africa or in other countries. It also meant that the prohibition on insider trading was extended to cover over-the-counter transactions in listed securities despite the fact that they are difficult to detect and to monitor. See Van der Lingen B "Tougher Legislation to Combat Insider Trading" (1997) Fourth Quarter *FSB Bulletin* 10.

file compensatory claims with the Financial Services Board.[90] In addition the King Task Group recommended that the responsibility for the enforcement of the proposed Act be vested in the FSB. For effectiveness, it also proposed the establishment of an Insider Trading Directorate as a division of the FSB[91] for purposes of investigating all alleged insider trading cases and to determine whether to refer criminal matters to the Director of Public Prosecutions for prosecution or whether civil action should be taken.

By accepting the recommendations of the King Task Group to regulate insider trading in a separate Act, the legislature followed the example of a number of other countries.[92] In so doing, it is clear that the authorities acknowledged that insider trading had a crippling effect on the efficiency and proper functioning of the South African financial markets and that the legislation on insider trading was not only inadequate but also ineffectively enforced[93] in the courts during the period prior to 1998. It was acknowledged further, that there was a need to restore public investor confidence in South African financial markets which can only be done in terms of a separate Act.[94]

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[90] The Financial Services Board (hereinafter referred to as the FSB) is an independent statutory body that was formed to ensure effective enforcement of the insider trading prohibition in both criminal and civil cases. It was established in terms section 2 of the Financial Services Act 97 of 1990. See http://www.fsb.co.za 20 May 2006.

[91] The Insider Trading Directorate was established as a committee of the FSB to perform many functions that include the investigation of suspected insider trading cases and to determine whether to take civil action or to refer criminal matters for prosecution. It had powers of search and seizure and to interrogate any person who was suspected to be guilty of insider trading. See Van Deventer G "New Watchdog for Insider Trading" (1999) First Quarter *FSB Bulletin* 3.

[92] The Insider Trading Act 135 of 1998 will be discussed in detail in Chapter 3.

[93] The researcher shares the view that the solution to the insider trading problem lies in the effective enforcement of such laws and that they should not only exist on paper. See for the enforcement of a civil remedy http://www.fsb.co.za and Van Deventer G *supra* note 90.

[94] This was in reaction to a submission of the King Task Group that global financial markets were characterized by stiff competition for investment and an assumption that investors were fleeing from South African financial markets because of the absence of an effective regulatory framework. Emerging financial markets (to which South Africa belongs) must therefore be free from insider trading.

CHAPTER THREE

THE INSIDER TRADING ACT, 135 OF 1998: INTERPRETATION AND APPLICATION.

3.1. INTRODUCTION.

A new regime aimed at curbing the insider trading problem in South Africa was introduced on 17 January 1999.[1] The Insider Trading Act, 135 of 1998 repealed and replaced the inadequate provisions of the Companies Act, 61 of 1973 in an effort to broaden the scope of the insider trading prohibition. In addition to treating insider trading as a criminal offence, an attempt was made to provide more effective civil remedies to those who would suffer prejudice as a result of insider trading activities. Furthermore, more severe criminal sanctions were introduced and the insider trading ban was extended to a wide spectrum of financial instruments other than securities of companies.

This Chapter seeks to analyse the provisions of the 1998 Act. The analysis is divided into three parts. Firstly a closer look will be taken at the meaning of insider trading and related concepts through an analysis of the definitions thereof. Secondly the provisions that relate to the prohibition on insider trading and penalties will be discussed. Lastly the adequacy and effectiveness of the civil remedies will be examined, as well as the defences as provided in the Act.[2]

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1 This is when the Insider Trading Act, 135 of 1998 (hereinafter referred to as the 1998 Act) came into force as a separate statute to regulate and control all insider trading activity in South Africa. It was made applicable to a wide range of insider trading activities which includes tipping. See Benade M L and others *Entrepreneurial Law* 3rd ed Lexis Nexis Butterworths Durban 2003 130.

2 The analysis is made in reaction to an assumption held by many persons that the 1998 Act like its predecessors failed to address all the negative consequences of insider trading in clear and unambiguous terms. The relevant provisions will be scrutinized to confirm whether this is the case. See Benade M L and others *op cit* note 1 130. Botha argues that the process of language is not

3.2. DEFINITIONS AND CONCEPTS.

3.2.1. The concepts of insider trading and related activities.

Insider trading was not expressly defined in the 1998 Act. However sections 2 and 6 enumerate a number of practices that would respectively give rise to criminal and civil liability for insider trading. It would amount to insider trading if any individual knows that he has non public price-sensitive inside information and deals directly or indirectly for his benefit or for the benefit of any other person, in securities or financial instruments to which such information relates or where the price of such securities or financial instruments is likely to be affected by such dealing.[3]

This obviously suggested that "an individual" could only become involved in insider trading activity if he had actual knowledge of the inside information,[4] either by virtue of being an insider as defined[5] or otherwise as a tippee being tipped off. Therefore the tippee will only be liable for insider trading if he would *knowingly* deal in securities or financial instruments on the basis of inside information as contemplated in sections 2(1)(a), 6(1) and 6(2)(c). The tipper on the other hand would become liable, by virtue of the specific prohibitions that apply to him, for disclosing price-sensitive information to others, (tippees) or for encouraging another person to deal in the securities to which the information relates[6] or for discouraging the other person from dealing in such securities.[7] It should be noted however that in all these cases, it was required that the tipper *knew* that he had inside information and that he *had acted* on the basis of that information. His actions or those of an ignorant tippee could still however seriously prejudice ignorant sellers or purchasers of the securities or financial instruments in

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complete if the message is not properly understood - see Botha C *Statutory Interpretation: An Introduction for Students* 3rd ed Juta and Company 1998 6.

3 See section 2(1)(a) and sections 6(1) and 6(2)(c) of 1998 Act.

4 See the definition of inside information as critically analysed in paragraph 3.2.3 of this Chapter.

5 See the definition of insider as discussed and analysed in paragraph 3.2.2 below.

6 See section 2(1)(b) and section 6(2)(b).

7 See section 2(2) and section 6(2)(a).

question, even where the tipper or tippee was unaware of the fact that the information amounted to inside information. The tippee could for instance be unaware of the fact that the inside information had not yet been made public or ignorant of the circumstances that caused the information to be price-sensitive.[8]

In cases of tipping or dealing on behalf of other persons, it was also not required that the tipper or the person so dealing had to receive any benefit from the transaction, or that he had to communicate the actual inside information and its potential impact to the tippee. A suggestion, encouragement or discouragement to deal or not to deal in securities or financial instruments would suffice.[9] The tippee would involve himself in insider trading only if the inside information had been communicated to him and he would deal on the basis thereof. The other persons who did not have access to the same information, could still be seriously prejudiced.

The 1998 Act did not contain a clear definition of the term "dealing",[10] although dealing, directly and indirectly in securities or financial instruments for personal benefit

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[8] It is not clear whether section 6 left room for the prospect of holding a tipper and a tippee jointly and severally liable for insider trading. This section was defective in so far as it implied that some persons could be innocently liable for the insider trading activities of other persons who could even escape liability. This was possible if a tippee would know the facts and circumstances but at the time of dealing on the basis thereof, he was ignorant of the confidentially of the information or its price-sensitiveness.

[9] Cognizance was not taken of the fact that not all insider trading affected the price of securities or financial instruments immediately after completion of the insider trading transaction. Therefore any premature and unathourised disclosure of inside information should have been prohibited irrespective of whether such disclosure directly affected or was likely to affect the price of any securities or financial instruments.

[10] This was a major deficiency in the 1998 Act. The failure to define "dealing" could contribute to ignorant insider trading. See sections 2(1)(a) and 6(1)(a). Unlike the position in South Africa, the term "dealing" was defined in the English Law to cover any direct or indirect acquisition or disposition of securities, either as principal for one's own account or for another. See section 55 of the English Criminal Justice Act of 1993. Also see Beuthin R C and Luiz S M *Beuthin's Basic Company Law* 3rd ed Butterworths 2000 235.

or for the benefit of another person, was expressly prohibited. A number of situations require closer scrutiny.

If A, on the basis of inside information about the affairs of X Limited, would acquire an option to purchase its shares at R10 per share and cede the option to B, the option would clearly fall within the definition of "securities" *or* "financial instruments".[11] However it is not clear whether all instances of *dealing* in such an option would amount to "dealing" as contemplated in the Act. The following situations can be considered:

(a) Suppose A does not exercise the option himself, but cedes the rights under the option to B before the information is made public and has any effect on the price or value of the shares and without disclosing such information to B. It is not clear whether a cession for no consideration (for example to a relative) would amount to "dealing" as contemplated even where it would enable B who was ignorant of the inside information, to obtain shares in X Limited at R10 a share at a time when the market value was for instance R100 per share.

(b) Even if the above situation been covered by the provisions of the Act, the question remains whether A would incur civil or criminal liability in terms of sections 2 or 6, either before or after B had dealt in the securities or financial instruments in question.

The cessionary B would of course only become an insider if he, at some time before exercising the option, would become privy to the inside information and thereafter take advantage of the situation by exercising the option. This would amount to "dealing" as contemplated in sections 2(1)(a), 6(1)(a) and 6(2)(c). Suppose however, that B had originally taken cession of the option for consideration but without any knowledge of the inside information. Would B be precluded from exercising the option if the information would be communicated to him at a later stage? In that case, it would be wise not to exercise the option until public announcement of the information is made.

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[11] See analysis in paragraph 3.2.5 of this Chapter.

Thus B cannot be said to have "dealt" *with the shares* on the basis of inside information even if he got them at a price that was lower than their market value at the time. Perhaps, only A should incur liability in this case, because he had dealt with the option (being a financial instrument) on the basis of inside information that he had at all relevant times.

The perception that only natural persons can be involved in or benefit from insider trading left room for *mala fide* and *selective disclosure* of price-sensitive information between companies in the same group, in relation to securities or financial instruments of any subsidiary or the holding company.[12] It could also result in insider trading by any company to the detriment of other innocent investors and there is no reason why the company should not, in addition to those who act on its behalf, be prosecuted and incur civil liability.

3.2.2. Who was an insider in terms of the 1998 Act?

There is less than full agreement as to who should qualify to be an insider, and there is considerable controversy on this issue, on the way in which, and the moment at which a person actually becomes an insider.[13] In terms of section 1 of the 1998 Act, *insider* means "an individual who has inside information through:

(a)(i) being a director, employee or shareholder of an issuer of securities or financial instruments to which the inside information relates; or

(a)(ii) having access to such information by virtue of his or her employment, office or profession; or

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[12] See paragraph 3.2.2 below. Insider trading can occur between departments of company, or benefit subsidiary companies who directly or indirectly deal in the securities or financial instruments. On the other hand another subsidiary company that does not have access to the price-sensitive inside information in relation to the relevant securities or financial instruments can be prejudiced in the event of *mala fide* selective disclosure. See the *Minority Report on Insider Trading* by The King Task Group into Insider Trading Legislation paragraph 3.4 as summarized Beuthin R C and Luiz S M *Beuthin's Basic Company Law* 3rd ed Butterworths 2000 235-238.

[13] See Loubser R "Insider Trading" (2002) http://www.jse.co.za 12 October 2006.

(b) where such individual knows that the direct or indirect source of the inside information was a person contemplated in paragraph (a)".

Two categories of insiders were therefore contemplated under the 1998 Act. Firstly there were the *primary insiders* such as the directors, employees or shareholders of an issuer of securities or financial instruments to which the inside information relates, and which include *fortuitous insiders* or individuals who have access to the inside information by virtue of their employment, office or profession but who are not officers or employees of the company itself.[14] Secondly there were *secondary insiders* or tippees, being individuals who know that their direct or indirect source of the inside information is a primary insider.

The focus in the definition on individuals as insiders clearly implies the exclusion of juristic persons. In this context the scope of the definition is too limited. Individuals can easily involve themselves in insider trading activities through juristic persons under their control. Should they be allowed to escape liability?[15] Some insiders mentioned in the definition such as directors and employees may owe the issuer a fiduciary duty not to disclose confidential information about the affairs of the issuer to outsiders but at the same time be under a duty in terms of the Act to disclose the same information to others if the company or the issuer would involve itself in insider trading.[16] This could easily

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[14] The guidelines provided in the Act for determining who qualifies to be an insider were inadequate. The pool of *individuals* who could become insiders was on the other hand large and included not only directors, employees and advisors but also many others, like advertising and production professionals engaged to compile and publish inside information for printing. See Loubser R *supra* note 13.

[15] Vicarious liability only exits where it is provided for in terms of general principles of law and the exclusion of juristic persons from the definition seems to exclude any prospect of vicarious liability being imposed on either the juristic person or any individual who practised insider trading under the guise of a juristic person. See section 6(11); Loubser R *supra* note 13.

[16] The Act was further silent on the question on whether insiders may be *liable to the issuer* of securities or financial instruments for breaching their fiduciary duties when merely disclosing confidential information to outsiders under these circumstances as opposed to abusing it for personal gain.

bring about tension between shareholders and management. The exclusion of companies and other juristic persons from the definition of an "insider" was therefore regarded by commentators as a serious flaw in the 1998 Act and a major compromise on the part of the legislature.[17]

Disclosure of inside information to a tippee could of course amount to a contravention of the provisions of the Act as well as a disclosure of confidential information to the detriment of the issuer to whom he may owe fiduciary duties as a result of which he would be liable to the issuer in terms of common law principles.[18] However any statute which provides for juristic persons to be liable for insider trading activities, should exempt an issuer from liability where it did not authorise the disclosure.

Furthermore, a fortuitous insider or a tippee would not strictly speaking have inside information within the meaning of sections 2 and 6 if they knew the facts but not the background that caused the information to be price-sensitive. A tippee could also be unaware of the confidentiality thereof. These persons could however cause prejudice to others by anonymously dealing in securities on a regulated market.[19]

It is important to note that proof of knowledge of inside information on the part of an insider was required. Actual appreciation on the part of the alleged insider, of the price-sensitive nature of the inside information was however not clearly required but the provisions of the 1998 Act imply that he can only be liable if he appreciates the price-sensitive nature of the information and acts upon it. Constructive knowledge could not be attributed to any person simply because he occupied a position which might have given him access to it.

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17 See Loubser R *supra* note 13.

18 *Ibid.*

19 See Heakal R "Defining Illegal Insider Trading" (2003) http://www.investopedia.com 18 June 2006. Also see Farrar J H and others *Farrar's Company Law* 3rd ed Butterworths London 1991 426. See paragraphs 3.3 and 3.4 for a detailed discussion of sections 2 and 4.

3.2.3. What constitutes inside information?

Insider trading could only occur if there was a prospect of abuse of "inside information". The definition of "inside information" must therefore be analyzed critically to establish whether it was adequate.

Inside information was defined as:

> "specific or precise information which has not been made public and which (a) is obtained or learned by an individual as an insider, and (b) which if it were made public would be likely to have a material effect on the price or value of any securities or financial instruments".

Not all information could therefore be treated as inside information for purposes of regulating insider trading. Only accurate and factual non public inside information would fall in the ambit of the definition. Information therefore had to meet five requirements to qualify as inside information in terms of Act.

Firstly, the information was required to be factually specific or precise. Inaccurate and any unconfirmed information, speculation about whether information might be true, rumours or promises were excluded. Trading on the basis of rumours or speculation about the value of securities or financial instruments could, however, still occur and harm ignorant outsiders.[20] The Act did not define the terms "specific" or "precise" and it was left to the courts to determine what would constitute specific or precise information. Although it can be assumed that all persons should have a broad understanding of the general meaning of these terms, everybody might not appreciate

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[20] Such persons could trade on the basis of rumours or speculation at their own peril while those responsible for the rumours could make enormous gains without incurring any liability for insider trading - see Loubser R "Insider Trading" (2002) http://www.jse.co.za 24 June 2005.

the degree of specificity or precision required for information to qualify. This obscurity may offer an opportunity to practise insider trading without incurring liability.[21]

Secondly, the inside information must have been information which could only be accessed by insiders, or where the source of the information was an insider. A consultant geologist who does prospecting work for his client, a mining company, would qualify as an insider by virtue of his profession as contemplated by section 1(a)(ii) and should incur liability if he would deal in shares of the company on the basis of price-sensitive inside information he had obtained while performing his duties. He knew that he had inside information. However, instances where the information originated in financial markets or sources other than the company were not included in the definition. This exclusion however also left room for abuse.[22]

It is therefore submitted that *any person* who would leak the inside information knowing that it was not yet made public (and not even communicated to the company) should be held liable to those prejudiced by his or her actions on basis of disclosing inside information as a tipper, to others.[23] Whatever the situation, the fact remains that price-sensitive information that is leaked *unintentionally* by insiders was not covered by the definition and could still have been abused recklessly by others.

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21 For example comments like "we are enjoying a good year" would probably not qualify, but the researcher contends that the absence of a definition leaves room for abuse in the form of rumour mongering.

22 Unscrupulous persons could take advantage of this and engage in insider trading without incurring liability - see Myburgh A and Davis B "The impact of South Africa's Insider Trading Regime on Market Behaviour" http://www.genesis-analytics.com 11 November 2006; Osode P C "Defending insider trading regulation on ethical and scientific grounds: The inequality of legal access theory" (1999) 62 *Journal of Contemporary Roman-Dutch Law* 20.

23 See the definition of "insider". Although insiders are the main sources of inside information, the Act ought to have recognized other potential sources of inside information to ensure effective combating of insider trading. See Fishe and Robe "The Impact of Illegal Insider Trading in Dealer and Specialist Markets: Evidence from a Natural Experiment" (2002) http://www.som.yale.edu 12 August 2005; Luiz S M "Insider Trading Regulation - If at First You Don't Succeed..." (1999) 11 *SA Merc LJ* 139.

Thirdly, the information must not have been made public. Various ways in which such information was deemed to have been published were enumerated in section 3. These will be analyzed below in paragraph 3.2.4.

Fourthly, the non public inside information *was required to be likely* to have a material effect on the price or value of the securities or financial instruments after having been made public. Appointment or resignation of a person as a director may for instance be considered as material in many instances but can it automatically be regarded as precise and likely to influence other persons *directly* or *indirectly* to deal, or discourage them from dealing in securities or financial instruments of the company concerned? The term "material effect" was not defined. This is another shortcoming because the degree of materiality might well be a mystery to many persons.[24] It was probably intended to be left in the discretion of the courts to decide whether a transaction resulted or was likely to result in having a material effect on the price of securities or financial instruments in a given situation.

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[24] According to the United States of America securities laws non public inside information is treated as information that have a material effect on the price of securities or financial instruments only if a reasonable investor was likely to consider it significant in making an investment decision or if it was reasonably certain to have a substantial effect on the market price of a company's securities. See http://www.sec.gov 12 July 2006. No similar definition would be found in section 1 of the 1998 Act and it cannot be stated with certainty that the same test would apply in South Africa. The researcher therefore alludes to the fact that the term "inside information" was not defined sufficiently and adequately for purposes of effectively curbing the insider trading problem in South Africa. For such a definition of inside information to be adequate it should be applicable to all non public inside information, *irrespective* of whether it actually had a material effect on the price of securities or financial instruments, as long as it was likely to have such a material effect.

3.2.4. The meaning of "publication".

Inside information seizes to be inside information for purposes of the Act upon its publication. The term "publication" was not defined and must be analyzed due to an assumption that non public price-sensitive inside information may be ignorantly abused because it is not always easy to establish the exact moment of publication and whether there was timeous publication. This is therefore also a controversial issue.

The researcher contends that the Act in section 3 simply narrated so-called guidelines for publication without actually explaining how such guidelines were to be used to ensure proper and timeous publication. This list of guidelines was also not exhaustive.[25] These guidelines can however be commended as at least an attempt to provide guidance as to what exactly constitutes publication without excluding other possible instances that were overlooked.

Section 3(1) provided that non public inside information shall be deemed as having been made public if:

(a) it is published in accordance with the rules of the relevant regulated market for purposes of informing investors and their professional advisors; or
(b) if it is contained in the records maintained by the relevant statutory regulator which by virtue of any enactment are open to inspection by the public; or
(c) if such information can be readily acquired by those likely to deal in any securities or financial instruments,
    (i) to which such information relates; or
    (ii) of an issuer of securities or financial instruments to which the instrument relates; or
(d) it is derived from information which has been made public.

Inside information was further deemed to have been made public where:

[25] See section 3.

(a) it can only be acquired by persons exercising diligence or expertise or by observation; or

(b) if it is communicated to a sector of the public and not to the public at large; or

(c) communicated only on payment of a fee; or

(d) if it was only published outside the Republic.[26]

One commentator however submitted that, although it was now clearer that the non public nature of inside information terminates upon its publication, there were still no mandatory disclosure requirements to encourage companies and other persons to effect a timely publication.[27]

The provisions of section 3(2) can however be criticized for being too simplistic and that they could easily be circumvented by persons who wanted to abuse inside information. For example it was still possible to publish the inside information in an unpopular local newspaper or a financial gazette that may not be read by the general public and escape liability on the basis that it was published to a section of the public. If the terms "public" or "a section of the public" are not defined, contravention of the Act is too easy and the researcher recommends a provision that is similar to the requirements for disclosure as embodied in Rule 2.4.1 of the SRP Rules which will be discussed in the next Chapter.[28]

3.2.5. The meaning of "securities" and "financial instruments".

Another important term that was defined in the provisions of the 1998 Act was "securities",[29] as *including* securities defined in section 1 of the Stock Exchanges

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[26] See section 3(2).

[27] See Osode P C "The New South African Insider Trading Act: Sound Law Reform or Legislative Overkill?" (1999) 44 *Journal of African Law* 239.

[28] See Chapter 4 paragraph 4.5. Failure to make a timely publication could well result from ignorance in relation to the meaning of concepts of "public" or who belonged to "a section of the public".

[29] See section 1.

Control Act, 1 of 1985 and any instruments or rights bearing substantially similar characteristics to such securities and which are dealt in on a regulated market. It can be argued that this definition was too restricted, because it only applied to securities or financial instruments traded on a regulated market.[30]

The term "financial instruments"[31] was defined as a financial instrument as defined in section 1 of the Financial Markets Control Act, 55 of 1989 and any instrument or right bearing substantially similar characteristics to any such financial instrument and which is dealt in on a regulated market. This definition could also be criticized for being *rigidly* and *narrowly* applicable, only to financial instruments dealt with on regulated financial markets.

3.3. PROHIBITION OF INSIDER TRADING, CRIMINAL OFFENCES AND PENALTIES.

3.3.1. Prohibition on actual insider dealing in securities or financial instruments.

The 1998 Act provided that "any individual who knows that he or she has inside information and who deals directly or indirectly, for his or her own account or for any other person, in securities or financial instruments to which such information relates or which are likely to be affected by it, would be guilty of an offence".[32] Four requirements had to be met before any person could be liable for contravening section 2(1)(a):

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30 In terms of section 1, a regulated market was any market whether domestic or foreign which was regulated in terms of the relevant legislation of the country in which that market conducted business as a market for dealing in listed securities or financial instruments.

31 See section 1.

32 Section 2(1)(a).

Firstly, the prohibition in section 2(1)(a), unlike the prohibition found in repealed provisions of the Companies Act, 61 of 1973,[33] only extended to natural persons. This implied that juristic persons were not prohibited from becoming involved in insider trading.[34]

Secondly, such an individual must have been aware of the fact that he or she had inside information. Thus knowledge was a prerequisite for criminal liability in terms of section 2(1)(a). Mere apprehension in the mind of the accused that he or she had inside information was sufficient for that person to commit the offence.[35]

Thirdly, it was immaterial whether the accused individual actually dealt in securities or financial instruments for personal benefit or for the benefit of another person. Dealing directly or indirectly for making a profit or avoiding a loss for oneself as well as for any other person was therefore prohibited in terms of section 2(1)(a). However the absence of a definition of the term "deal" or an explanation of what constituted "dealing" could cause an individual to become involved in insider trading innocently and ignorantly.

Lastly, dealing in securities or financial instruments was prohibited, only if the individual concerned had information which had a material effect or was likely to have a material effect on the price of those securities or financial instruments. The meaning

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[33] Previously the offence of insider trading could be committed by any "person" - see section 440F (1) of the Companies Act 61 of 1973. The definition of "person" in terms of the Interpretation Act 33 of 1957 includes natural and juristic persons. This means that in terms of section 440F (1) the insider trading offence could be committed by both natural persons (individuals) and juristic persons (companies or institutions). The researcher argues that the reference to "individual" instead of person in the 1998 Act might have been a step in the wrong direction.

[34] The failure to impose criminal liability on juristic persons who engaged in insider trading was one of the major weaknesses in the Act. See Beuthin R C and Luiz S M *op cit* note 12 235-238; Chanetsa B "Insider is notoriously hard to prosecute" *Business Report* 26 April 2004.

[35] The onus of proof was on the prosecution to prove beyond reasonable doubt that the accused was aware that he was in possession of inside information. A plea of ignorance or lack of knowledge by the accused even in the slightest degree was sufficient for acquittal, even where the accused had made enormous personal gains or had assisted another person to acquire such gains.

of the term "material effect" and the exact moment at which such *material effect* had to be present was however not stated and it was apparently left to the courts to decide.[36] The same seems to have applied to the *unanswered* question as to what was the required degree of materiality for purposes of section 2(1)(a).

3.3.2. Prohibition on encouraging or discouraging another person to use inside information when dealing in securities or financial instruments.

The 1998 Act also prohibited tipping. Section 2(1)(b) provided that "any individual who knows that he or she has inside information and who encourages or causes another person to deal or discourages or stops another person from dealing in securities or financial instruments to which such information relates or which are likely to be affected by it, shall be guilty of an offence".

This prohibition was aimed at discouraging persons who were privy to non public price-sensitive information to incite others to deal or to refrain from dealing in securities or financial instruments to the detriment of innocent outsiders (public investors) who were at an informational disadvantage.[37] Contravention of section 2(1)(b) was only possible if the following requirements were met:

Firstly, the prohibition again applied only to natural persons and unlike the position under repealed provisions of the Companies Act, 61 of 1973,[38] juristic persons were not

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[36] It was therefore possible that a person could escape criminal liability on the basis of ignorance although he had in fact dealt on the basis of information that *has or was likely to have a material effect* on the price of securities or financial instruments. See Bridge S and Morris R "Saambou bosses face fraud charges" *Business Report* 15 September 2005.

[37] This follows the assumption that tippers usually tip off their relatives and friends irrespective of whether it takes place for mutual benefit or merely to benefit the relatives or friends. As a result of receiving tips from the tippers (insiders), the tippees stand a better chance of avoiding a loss or making enormous profits at the expense of investors who are ignorant of such price-sensitive information - Heakal R *supra* note 19.

[38] See the comments on section 440F(1) of the Companies Act, 61 of 1973 in paragraph 3.3.1.

covered. Therefore only individuals and not juristic persons on behalf of which they might act, could be convicted in terms of section 2(1)(b).

Secondly, the individual must have been aware that the information he had was inside information. The prosecution was not required to prove for purposes of subsection (1)(b) that he had actually communicated the inside information concerned to the tippee. A mere suggestion to buy or sell or to retain the securities or financial instruments would suffice. The tippee would be guilty of an offence, only if he, as a result of the tip, knew that he actually had inside information and traded on the basis thereof as contemplated in section 2 (1)(a). It appears that mere apprehension in the mind of the accused that he was armed with non public inside information was also in this situation, sufficient to incur criminal liability.

Thirdly, liability for contravening section 2(1)(b) was solely based on the encouraging to deal or discouraging another person from dealing in securities or financial instruments irrespective of whether the tippee actually acted on the tip. Section 2(1)(b) did not proscribe what constituted illegal conduct on the part of the tippee.[39] Thirdly, it was immaterial for the purpose of incurring criminal liability, whether the tipper had made profit or avoided some loss. Substantial prejudice could of course still be caused to ignorant third parties, even where the tippee would merely deal or refrain from dealing in securities or financial instruments in reaction to a tip-off.

Lastly, section 2(1)(b) specifically prohibited tipping in relation to dealing in listed securities or financial instruments and not tipping in relation to other securities or instruments. This was another glaring omission in the 1998 Act.

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[39] Section 2(1)(b) focused only on the liability of tippers and overlooked the fact that not only tippers (insiders) were the perpetrators of insider trading. See Loxton L "Deutsche saga ends in R24m fine" *Business Report* 8 April 2004.

3.3.3. Prohibition on disclosure of inside (confidential) information.

Section 2(2) provided that: "subject to section 4(2), any individual who knows that he or she has inside information and who discloses that information to another person, shall be guilty of an offence". It prohibited improper disclosure of non public price-sensitive inside information. The use of the term "individual" in section 2(2) once again implied the exclusion of juristic persons and a natural person could only be guilty of the offence if he was fully aware that he was in possession of inside information.[40] The prohibition did not extend to innocent disclosure by an individual who was *ignorant* of the fact that the information had not yet been made public.[41] On the other hand *mere disclosure* of information by a person *who knew* that it was inside information, was sufficient to constitute an offence in terms of the section, irrespective of whether it was acted upon or not.[42]

3.3.4. Criminal liability, penalties and effectiveness of the criminal sanction.

Any individual convicted of an offence in terms of section 2 could be sentenced to a fine not exceeding R2 million or imprisonment for a period not exceeding 10 years or both such fine and such imprisonment.[43] It appears as if the Act only stated the

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[40] That is if the accused could not prove any defences proscribed in section 4(2).

[41] For instance a receptionist of a company who overheard the directors celebrating the company's good financial results and later innocently and ignorantly disclosed that to her friend who then purchased shares on the basis thereof, could not be convicted under section 2(2).

[42] For example if a director while addressing a family gathering at a party, accidentally disclosed his company's good results before they were made public. Even though his conduct was not intentionally aimed at inciting any person to deal in the company's securities or financial instruments, he may find it difficult to prove that he had reasonable grounds to believe that no person would react and deal in the company's shares to constitute a defence in terms of section 4(2)(a). The provision can in this situation be regarded as rather draconian but it would on the other hand discourage directors or officers from making careless statements. Perhaps the legislature should have added more defences to avoid conviction of innocent persons, who did not intentionally abuse inside information for gain. See Osode P C *op cit* note 27 239.

[43] See section 5.

maximum penalty for insider trading and did not impose maximum penalties separately, for any of the other offences created in terms of section 2. This, on the one hand could be regarded as rather absurd, considering the fact some of the offences could be regarded as offences of a less serious nature. For instance it was irrelevant whether the person simply encouraged or discouraged another person from dealing or whether he actually dealt in securities or financial instruments. The courts could impose the same sentence in such cases. This indicates that careful consideration was not given to the appropriateness of penalties for different offences.

There can, on the other hand, be little doubt that the legislature had deterrence in mind as its main tool to combat insider trading in South Africa. Its focus on deterrence came under fire from commentators who submitted that the policy goal of deterrence alone, was not sufficient to curb the insider trading problem. It was further submitted that the R2 million fine and the 10 years term of imprisonment were not sufficient to deter persons from getting involved in insider trading activities.[44] Other commentators however argued that the criminal penalties were too severe and even draconic in nature. The researcher supports the view that the penalties were too low for deterrence purposes.[45]

The onus of proof was on the prosecution to prove beyond reasonable doubt the elements stated in section 2. Criminal liability was not contingent on the accused making any profit or avoiding a loss, but merely on the fact that he had knowingly dealt in securities or financial instruments for personal benefit or for the benefit of another person.

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[44] It is widely accepted that gains from insider trading activity will often be substantially more than the maximum penalty. Offenders might well pay the R2 million fine or go to prison and still enjoy their ill-gotten gains. See Van der Lingen B "Tougher Legislation to Combat Insider Trading" (1997) Fourth Quarter *FSB Bulletin* 10.

[45] The researcher contends that although there was an apparent increase in the number of *investigations* since the inception of the Act, this was no reflection of the criminal sanction being effectively enforced in the courts but rather an indication that many persons were still practising insider trading without any fear of incurring criminal liability. See Van der Lingen B *op cit* note 44 10.

Credit must be given to the legislature for adopting an intolerant and strong stance against the practice of insider trading and for imposing significantly increased penalties on guilty offenders. One can easily be tempted to conclude that the criminal sanction would be effective, but the absence of reported successful prosecutions suggests otherwise. Perpetrators could still thrive on insider trading with impunity. The researcher alludes to the fact that the success of any legislation must be measured by the level of its effective enforcement in the courts. It is against this background that a thorough analysis of the criminal sanction in terms of the 1998 Act must be made. It must be noted also that after its inception, only a few cases were reported and no one was successfully prosecuted. Several reasons can be given for the fact that the criminal sanction seemed to be ineffective.

Firstly, provision should have been made for separate maximum sentences for persons who actually traded on the basis of inside information for personal benefit or for the benefit of others and those who merely encouraged or discouraged others from dealing in securities or financial instruments or disclosed inside information to others.

Secondly, the fact that the prosecution had to prove beyond reasonable doubt all the elements in section 2, especially that the accused knew that he had inside information placed an extreme onerous burden of proof on the prosecution. This might well be the reason for the absence of many reported convictions. Perhaps, provision could have been made for presumptions similar to those under the repealed section 440F.

Thirdly, the courts and the Director of Public Prosecutions did not have the capacity to conduct effective and timeous prosecutions. Although the FSB was empowered in terms of the Act to regulate insider trading, the prosecuting function vested in the courts. The everlasting backlog in our criminal courts must surely have delayed criminal prosecutions for insider trading as well. Therefore the FSB ought to have been empowered to initiate prosecutions in insider trading cases, in special courts that specifically deal with matters related to insider trading.

3.4. CIVIL LIABILITY, CIVIL REMEDIES AND CIVIL PENALTIES.

3.4.1. Liability for actual dealing in securities or financial instruments for own account.

In terms of section 6(1)(a), "any individual who knows that he has inside information and who deals directly or indirectly, for his or her own account in securities or financial instruments to which such information relates or which are likely to be affected by it" could be ordered to pay to the FSB an amount as provided for in section 6 (4) (a).[46] Section 6(1)(a) was enacted to enable the FSB to assist prejudiced persons to be compensated by any individual who practised insider trading for his own benefit. The onus of proof was on the FSB to prove on a balance of probabilities that:

(a) the individual concerned knew (was aware),
(b) that he had inside information, and that
(c) he directly or indirectly dealt in securities or financial instruments,
(d) that the information related to those securities or financial instruments or that the price was likely to be affected by it and
(e) that he had dealt in those securities or financial instruments for his own account.

This onus of proof was arguably too severe and difficult for the FSB to discharge. Many victims of insider trading might have refrained from lodging their claims with the FSB because of the fact that they would only receive compensation if there was a

[46] It was argued that negotiations towards settlements may delay proceedings in civil cases. This was evidenced by the long protracted battle that started on 6 September 1999 between the Financial Services Board (FSB) and a cosmetics company called Beige (BG). Despite serious insider trading offences that were allegedly committed by some senior executives of BG, the court merely treated it as fraud. Only one of the directors (Sydney Rogers) paid R800 000 for the alleged fraud without admitting liability for insider trading. No compensation for the alleged insider trading was paid to FSB to date. See Gebhardt M "Beige, our own mini-Enron redeems itself" (2004) http://www.busrep.co.za 14 April 2006.

surplus after deduction of the costs charged by FSB in a successful suit.[47] Only the FSB was entitled to institute civil proceedings in a competent court and there was no provision in the 1998 Act for direct claims for compensation by victims against offenders.[48] This also discouraged many affected persons from claiming their compensation through the FSB.

In terms of section 6(1)(b), "any individual who knows that he or she has inside information and who profits or avoids a loss through such dealing" could be ordered to pay to the FSB an amount as provided for in section 6(4)(a).[49] The defendant would be liable to the FSB unless he could prove one of the defences proscribed in the Act. Section 6(4)(a) will be discussed later but it essentially provided that the FSB was entitled to sue for an amount equal to the profit the defendant had actually made or the loss he had avoided and in addition, a *penalty* not exceeding 3 times the profit made or loss avoided plus interest and legal costs. The onus was therefore on the FSB to prove on a balance of probabilities, the amount of the profit made or the loss avoided. The FSB was allowed to recoup its costs from any amount recovered before distributing any balance to the persons who had been affected by the transaction in question and who lodged their claims with it.[50] It is however submitted that to expect the FSB to prove the actual loss avoided or profit made, might well be an up-hill task.

3.4.2. Liability for disclosure of price-sensitive information.

In terms of section 6(2) "an individual who knows that he or she has inside information and who discloses that information to an individual referred to in subsection (1) and fails to prove on a balance of probabilities any one of the defences set out in section

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47 See section 6(4)(a). Although the defendant could also be ordered to pay the costs and interest, the FSB was entitled to its expenses before any balance was distributed to affected victims.

48 The procedure for claiming compensation was provided for in sections 6(6)-(11). These sections will not be discussed in detail here but the role of the FSB will be analyzed in Chapter 4.

49 See Van Deventer G "New Watchdog for Insider Trading" (1999) First Quarter *FSB Bulletin* 3.

50 See Chanetsa B "Insider trading is notoriously hard to prosecute" (2004) http://www.busrep.co.za 13 January 2006.

4(2) or any other defence available to him or her" could be ordered to pay an amount as provided in section 6 (4)(a).

However, the researcher alludes to the fact that the 1998 Act did not adequately provide practical procedures and steps aimed at stopping the non public price-sensitive inside information from leaving companies and financial markets prematurely and unlawfully. The 1998 Act lacked mandatory disclosure requirements hence it was grossly inadequate. The onus of proof was on the FSB to prove on a balance of probabilities the elements of section 6(2)(a), especially that the defendant knew that he had inside information.[51]

Another shortcoming of section 6(2)(a) was that it did not state how the total amount of compensation was to be determined. The actual amount of compensation for the affected persons was not contingent upon the actual loss or harm that they had suffered and it was left to the courts to determine.[52] Therefore in spite of the availability of some guidelines that were enacted to assist the courts in their determination of an appropriate amount for compensation, there was still a possibility that many affected persons would receive insufficient or no compensation at all.

Not many cases were settled through the FSB despite the fact that it was cheap and affordable, perhaps due to an alleged fear on the part of complainants that that they might fail to satisfy the FSB's stringent requirements for lodging and proving their claims.

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[51] The tipper and tippee were jointly and severally liable for a civil penalty in terms of section 6(4)(a) if they had acted as provided in section 6.

[52] See section 6(3)(b).

3.4.3. Liability for encouraging or causing another person to deal in securities or financial instruments.

The 1998 Act prohibited tipping and section 6(2)(b) provided further that an individual who knew that he had inside information and who deliberately encouraged or caused another person to deal in securities or financial instruments to which such information related, or which were likely to be affected by it and failed to prove on a balance of probabilities any one of the defences set out in section 4(1) or any other defences available to him, could be ordered to pay to the FSB the compensatory amount stipulated in section 6 (4)(a).[53]

An interesting point to note is that the wording of section 6(2)(b) did not expressly refer to liability for individuals who *stopped* or *discouraged* other persons from dealing in any securities or financial instruments. In this section the emphasis was placed on individuals who caused or encouraged others to deal in any securities or financial instruments.[54]

Notwithstanding the fact that both subsections (2)(a) and (2)(b) imposed civil liability for tipping and encouraging other persons to deal in securities or financial instruments, these provisions were still inadequate and ineffective. Moreover the FSB was possibly not adequately equipped and failed to effectively monitor and enforce these provisions.

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[53] The Act imposed joint and several liability on the tippee and the tipper following an assumption that both these parties enjoyed illicit gains from tipping at the expense of other investors. See Myburgh A and Davis B "The impact of South Africa's Insider Trading Regime on Market Behaviour" http://www.genesis-analytics.com 12 June 2006.

[54] The tipper may escape civil liability on the basis that he *did not* act contrary to section 6(2)(b) because it only prohibited *encouraging* such a person to deal in the securities or financial instruments concerned. See the "Report on the observance of standards and codes (ROSC), Corporate governance country assessment, Republic of South Africa" (2003) by the World Bank on http://www.genesis-analytics.com 13 May 2007.

Its monitoring methods were allegedly too unsophisticated for purposes of stopping persons from being involved in these activities.[55]

3.4.4. Liability for dealing in securities or financial instruments for another person's account.

The 1998 Act introduced civil liability for individuals who knowingly dealt directly or indirectly in securities or financial instruments on behalf of any other person in terms of section 6(2)(c). It provided that, "an individual who knows that he or she has inside information and who deals directly or indirectly in such securities or financial instruments for any person and fails to prove on a balance of probabilities any one of the defences set out in section 4(1) or any other defences available to him or her, shall be jointly and severally liable, together with the individual referred to in subsection (1), at the suit of the Financial Services Board to pay to the Financial Services Board the amounts set out in subsection (4)(a)(i),(iii) and (iv)". Any person who entered into any unlawful dealing on behalf of any other person could therefore incur civil liability in terms of this subsection irrespective of his or her relationship with the latter person.[56]

Although there was no definition in the Act of the term "dealing" in securities or financial instruments, one can assume that in this context it referred to the actual buying and selling of securities or financial instruments for the benefit of another person. Civil liability in terms of section 6(2)(c) was possible only if it was proved on a balance of probabilities that the defendant had knowingly involved himself in insider trading on behalf of another person. Liability was strictly based on actual dealing and any *attempt to deal* in securities or financial instruments seemed to fall outside the ambit of section 6(2)(c).

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[55] See paragraph 3.4.7 below.

[56] It was no defence for a person to argue he had no relationship with or had no intention to benefit the other person.

3.4.5. The requirement of knowledge as the basis of civil liability.

Knowledge on the part of the defendant that he or she *had inside information* was a prerequisite for any civil liability in terms of section 6. This meant that the FSB had to prove on a balance of probabilities that the defendant was aware of the fact that the information he possessed was in fact inside information. Unfortunately this implied that even the slightest degree of ignorance on the part of the defendant was sufficient to enable him to escape civil liability and the uncertainties in relation to the meaning of publication which were pointed out earlier[57] aggravates the matter.

The knowledge had to pertain to non public inside information that related to or was likely to have a material effect on the price of the securities or financial instruments in question. Already published information did not attract civil liability unless such publication was not made in terms of section 3. Unlike insider trading legislation in some other countries, the 1998 Act merely required knowledge on the part of the defendant in the sense that he had accessed the non public inside information and was dealing on the basis thereof. Proof of *intent* to *abuse* such information or to benefit himself or some other person was not required.[58]

Cognizance must be taken of the fact that insider trading was and will always be difficult to detect and many victims of insider trading are initially unaware of the fact that they act to their detriment or are being defrauded by anonymous insiders. Many persons were also ignorant of the consequences of insider trading.[59] Furthermore, unscrupulous persons could get away with insider trading activity. Others could innocently and ignorantly be involved in insider trading while under the impression that

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[57] See paragraph 3.2.4 above.

[58] In the United States of America the plaintiff is obliged to prove that the defendant deliberately abused the non public inside information to which he was privy, through engaging in insider trading for his own benefit or for that of another person – see http://www.sec.gov 12 April 2007.

[59] Although the FSB and Johannesburg Securities Exchange (JSE) have a played a pivotal role in educating investors about insider trading, a substantial number of persons are even today still ignorant of its negative effects.

the information which they had received as a tip had already been made public. These innocent persons could not incur civil liability, but their dealings could still prejudice outsiders. It could therefore be argued that the 1998 Act on the one hand overemphasized the requirement of knowledge and on the other failed to provide suitable civil remedies for all possible situations.

3.4.6. Liability for actual loss avoided or profit made.

Liability for actual loss avoided or profit made is stipulated in section 6(4)(a) as follows:

> "The Financial Services Board shall be entitled to sue by way of civil proceedings in any court of competent jurisdiction for the payment of:
>
> (i) the amount by which the individual referred to in subsection (1) profited or the loss which he or she avoided as a result of such dealing; and
> (ii) a penalty, for compensatory or punitive purposes, in a sum determined in the discretion of the court but not exceeding three times the amount of the profit gained or the loss avoided as a result of such dealing; and
> (iii) interest; and
> (iv) costs of suit on such scale as may be determined by the court".

Although the Act appeared to have empowered only the FSB with the powers to monitor and to enforce the civil remedy cheaply and effectively, such powers were insignificant insofar as they did not include powers to determine the compensatory amount for the prejudiced persons.

Moreover, only the courts had a discretion to determine the actual amount of the profit made or loss avoided in terms of section 6(4)(b), which provided that, "the amount of the profit gained or loss avoided shall be determined in the discretion of the court which shall have regard to factors such as the consideration for the dealing referred to in

subsection (1), the time between the relevant dealing and the publication of the inside information and any other relevant factors".[60]

Although it can be argued that any victim of insider trading activity may still proceed in terms of the common law principles of fraud or misrepresentation in any court, this apparently, has never happened due to a lack of evidence. Proceedings under section 6(4)(a)(i) may be instituted in any competent court. One can reasonably assume that they will be instituted in the High Court of South Africa. However the backlog in the various divisions of the High Court is well known and it is possible that many cases may be delayed or even abandoned. If provision is made for a specialist court, effective and timeous settlements of civil cases would be enhanced.

3.4.7. Effectiveness of the civil remedy.

Ineffective enforcement of the civil remedy has been a problem, as was the case with enforcement of insider trading laws in South Africa generally.[61] In spite of the fact that South Africa was the first country to introduce civil remedies and in spite of all the efforts made by the legislature to enhance enforcement thereof, the flaws in section 6 undermined the successful enforcement of its provisions. The weaknesses of these provisions should be exposed to show the way forward in formulating effective rules to

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[60] The researcher contends that in addition to the courts, an open approach ought to have been adopted to accommodate input from institutions like the JSE and BESA in the enforcement of the civil remedy, for it to be more successful and effective.

[61] Very few settlements were recorded in civil proceedings since the enactment of the 1998 Act. It is generally believed that delays or failure to claim compensation was due to inadequate and ineffective enforcement of the legislation. This view was supported by Chanetsa who in his submissions cited a civil case that involved the Deutsche Securities (DS) and the Financial Services Board (FSB). The negotiations towards a settlement commenced on 13 April 2000 and ended in 2004. This meant that this case took about four years before it was settled for a fine of R24 million. See Chanetsa B "Insider trading is notoriously hard to prosecute" *op cit* note 50.

regulate and to enforce insider trading in South Africa.[62] The failure and ineffective enforcement of the civil remedy was attributed to a number of factors which included the following:

Firstly, the onus of proof in terms of section 6 was on the FSB to prove on a balance of probabilities that the defendant knowingly exploited the non public inside information to deal in securities or financial instruments for his own benefit or for the benefit of another. It is however generally agreed that the FSB failed to effectively claim compensation on behalf of affected persons because the evidentiary burden was severe and difficult to discharge.

Secondly, although section 11(1) entrusted the FSB with the sole responsibility and with wide powers to monitor and to enforce the civil remedies[63] and although this was a noble move towards effective enforcement of the civil remedies, the FSB was probably not adequately equipped and financed to deal effectively and timeously with claims.

Thirdly, the procedures to curb the insider trading activity are still inadequate and other regulatory bodies such as JSE and stakeholders should be statutorily engaged to participate in the enforcement of the civil remedies. The FSB should be adequately resourced and funded to acquire technologically advanced equipment needed to effectively detect and monitor occurrence of insider trading activities and to effectively enforce the civil remedies. Although the Insider Trading Directorate (ITD) was established in terms of section 12 to investigate all suspected insider trading in regulated financial markets, it failed to carry out its proscribed duties, perhaps because of insufficient resources.[64]

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[62] Discussion of all the provisions of the Act in relation to enforcement of the civil remedies is beyond *the scope of this subheading.* Therefore sections 7-18 will be referred to only were necessary.

[63] The FSB was empowered to manage and to enforce the civil remedy to ensure that all persons affected by insider trading received compensation in terms of section 6(7). See section 11(1).

[64] Although the Insider Trading Directorate was established specifically to investigate all suspected cases of insider trading and was allegedly staffed with professional persons who had forensic and prosecutorial skills, it failed to settle many civil cases. This was evidenced by protracted delays in

3.5. AVAILABLE DEFENCES AND EFFECTIVENESS THEREOF.

A number of defences were made available for persons who allegedly violated the provisions of the Act.[65] No criminal or civil liability was imposed on any individual who proved on a balance of probabilities any of the defences that were provided in sections 4(1) and 4(2). It must be noted however that the statutory defences were not exhaustive and accused persons or defendants were also allowed to rely on any other defence that might have been available to them.[66] The statutory defences are the following:

Firstly, any individual would not incur any liability if he proved on a balance of probabilities that he was acting on specific instructions of a client unless it was actually that client who had disclosed the inside information to him. This meant that the accused or defendant was not liable if he was unaware of non public inside information that was relevant to the client's transactions. Professional negligence on the part of these persons would however exclude reliance on this defence.[67]

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arrests made and the unsuccessful claims for compensation in connection with the R640 million Saambou Bank saga. See Bridge S and Morris R "Saambou bosses face fraud charges" http://www.busrep.co.za 18 August 2006.

65 The defences were contained in section 4.

66 This was clearly stated in section 4(3) which allowed reliance on any other defence available for example in terms of common law. This provision was however received with mixed feelings. Some persons argued that the inexhaustible nature of defences was good because it afforded the accused or defendant a fair chance to defend himself while other commentators submitted that the failure to provide for a specific number of defences indirectly assisted some unscrupulous individuals to practise insider trading hoping that they could rely on some kind of defence to avoid liability. See Osode P C *op cit* note 27 239.

67 Section 4 (1)(a). Where the non public inside information was disclosed to an accused or defendant who relied on this section it can reasonably be expected of him to refuse to carry out the principal's instructions. It is however submitted that this can only be the case if the accused or defendant actually knew that he (now) had inside information as stipulated in the Act. A person who received the non public inside information from a client and who reasonably executed his duties on the premise that the information would not have a material effect on the price of the securities or

Secondly, persons who proved on a balance of probabilities that they would have acted in the same manner even if the inside information was not disclosed to them were exempted from liability.[68] This defence would probably only suffice if the defendant or accused concerned could demonstrate a good track record of buying and selling securities or financial instruments in similar transactions. The veracity of this defence would probably depend on different individuals being implicated in different cases. It must therefore be conceded that very few persons if any, would have successfully relied on it.

Thirdly, any individual who proved on a balance of probabilities that he was acting on behalf of a public sector body in pursuit of a monetary policy, policies in respect of exchange rates, management of a public debt or foreign reserves would not incur any liability.[69] This defence allowed for dealing in securities or financial instruments in pursuit of matters relating to monetary policy or the public interest. Although it was intended to assist any person who might have innocently traded in securities or financial instruments without the intention of prejudicing any other person, it was prone to abuse by government officials.

Fourthly, an individual could escape liability if he or she proved on a balance of probabilities that his or her dealing was in pursuit of the completion or implementation of an affected transaction as defined in section 440A of the Companies Act, 61 of 1973. This defence was aimed at ensuring that lawful conclusion of mergers and acquisitions were not frustrated. Completion of an affected transaction was preceded by comprehensive disclosure of inside information in terms of section 440A, under the supervision of the Securities Regulation Panel.[70]

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financial instruments or who was brought under the impression that the information had already been made public, should also be allowed to rely on the defence in section 4(1)(a).

[68] Section 4(1)(b).

[69] Section 4(1)(c).

[70] See paragraph 4.5 of Chapter 4 for a discussion of the SRP Rules in relation to disclosure.

Fifthly, persons who allegedly disclosed non public inside information as contemplated by sections 2(2) and 6(2)(a) could escape liability by proving on a balance of probabilities that they reasonably believed that no person would deal in securities or financial instruments as a result of such disclosure.[71] Thus unintentional and innocent disclosure of non public inside information could be a defence.

Lastly, no liability was imposed for disclosure of inside information if it was proved on a balance of probabilities, that the information was disclosed in the proper performance of the office, employment or profession of the person concerned and if at the same time it was disclosed that such information was essential in relation to that transaction.[72] This defence protected all *bona-fide* disclosures of non public inside information made by a person in course of his employment or office on behalf of the company or in a professional capacity. The question remained what was meant by the term "proper performance" of functions. One can argue that this term was self explanatory. However if its meaning is not properly understood, reliance on this defence may fail due to ignorance.

3.6. CONCLUDING REMARKS.

The 1998 Act can be welcomed as a step in the right direction to effectively regulate insider trading in South Africa and to address the widely accepted belief that insider trading was a general practice in South Africa. Significant progress was therefore made in the battle against insider trading in this country. For instance, in an attempt to attain a proper regulatory regime, it introduced a more elaborate civil remedy, and the ITD was established as an investigatory arm of the FSB, while various definitions of concepts, as well as new penalties and defences were introduced.

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[71] Section 4(2)(a).

[72] Section 4(2)(b).

It is, however, unfortunate to note that various gaps and flaws could still be found in the provisions of this Act.[73] No timeous settlement was for instance recorded in civil cases. Only one case was reported for prosecution since the inception of the insider trading ban. Penalties were still significantly low, defences were inadequate and generally speaking its provisions still reflected several shortcomings.

[73] Also see generally Gilmour C "Surveillance exchange shows its cleaner face" http://www.free.financialmail.co.za 16 May 2006.

CHAPTER FOUR

PROHIBITION OF INSIDER TRADING UNDER SECURITIES SERVICES ACT, 36 OF 2004.

4.1. INTRODUCTION.

The Insider Trading Act, 135 of 1998,[1] was notably inadequate and ineffective as was discussed in the previous Chapter. In another attempt to make the South African insider trading legislation adequate, effective and more comparable to the highest standards of similar legislation in the developed world, it was repealed and replaced by the Securities Services Act, 36 of 2004.[2]

Apart from repealing the 1998 Act, the New Act also consolidated the law relating to the regulation and control of exchanges and securities trading such as the Stock Exchanges Control Act, 1 of 1985, the Financial Services Board Act, 97 of 1990, the Financial Markets Control Act, 55 of 1989 and the Custody and Administration of Securities Act, 85 of 1992.[3] It is submitted that the consolidation was inevitable for purposes of introducing adequate and more effective legislation to free the South African financial markets and companies from illicit practices such as insider trading.[4]

Although some amendments and new offences for market abuse practices were introduced by the New Act, many deficiencies in the 1998 Act were simply carried over into the New Act. It is against this background that this Chapter seeks to investigate and expose these deficiencies for purposes of recommending practical measures that may be taken to resolve the insider trading problem in South Africa.[5]

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1 The Insider Trading Act 135 of 1998 is hereinafter referred to as "The 1998 Act".

2 The Securities Services Act 36 of 2004 is hereinafter referred to as "The New Act".

3 The New Act came into effect on 1 February 2005.

4 See Du Plessis R and Cassim R "The Securities Services Act 36 of 2004" http://www.bowman.co.za 18 August 2006.

5 This is necessary to remove the perception held by some persons that the South African legislation on insider trading is "a bark and no bite legislation". See Henning J J and Du Toit S "The regulation of

This Chapter will further discuss whether the current regulatory framework has successfully fulfilled its objectives, which are purportedly aimed at reducing systemic risk, protecting regulated persons and increasing public investor confidence in the South African financial markets[6] or whether it has failed. Therefore an analysis into the adequacy and effectiveness of the insider trading provisions as contained in the New Act will be carried out in this Chapter, as well as a critical examination of the penalties, defences and remedies proscribed in the New Act.

This will include, further, a discussion of other related market abuse practices such as tipping. Furthermore, the role of the Financial Services Board (FSB), the Directorate for Market Abuse (DMA) and the Enforcement Committee (EC) will be analysed, to determine whether these bodies are enforcing the anti-insider trading provisions effectively. It appears as if many of the allegedly inadequate provisions of the 1998 Act were simply retained in the New Act with little or no changes to them,[7] so that it is still possible for non public price-sensitive information to be abused by persons for their personal benefit or for the benefit of others.

The perception exists that the New Act brought significant improvements to the regulation of insider trading in South Africa. There can be no doubt that the consolidation into a single Act of all the previous legislation relating to the regulation and control of exchanges and securities trading, was an attempt to improve and resolve some of the problems found in the repealed legislation.[8] For purposes of this research, attention will be focused on the significance and desirability of the repeal of the1998 Act.

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false trading, market manipulation and insider dealing" (2000) 25(2) *Journal for Judicial Science* 155 163.

6 See section 2 of the New Act.

7 See sections 73(1)(a), 73(2)(a), 73(3)(a), 73(4), 74, 77(1), 77(2), 77(3) and 77(4) of the New Act. Mere amendment or repealing of the legislation relating to insider trading without necessarily dealing with the flaws and deficiencies in the previous legislation will not resolve the insider trading problem in South Africa. See Jooste R "A critique of the insider trading provisions of the 2004 Securities Services Act" (2006) 123 *SALJ* 437.

8 See section 117 of the New Act and the schedule for a list of repealed legislation.

The researcher however still submits that what is crucially needed is adequate and effective legislation to regulate insider trading irrespective of whether it is embodied in a consolidated Act or in several statutes.

Firstly, it should be noted that the scope and application of the insider trading prohibition is still limited to transactions in securities listed on regulated markets.[9] Insider trading may however also occur in unregulated financial markets, for example trading in securities of unlisted companies or government and semi-government bonds.[10]

Secondly, it is submitted that the express exclusion of money market instruments that may or may not be listed on regulated markets from the ambit of the definition of "securities" may in future turn out to be a mistake.[11] Here the insiders will be persons with expertise and inside information in relation to interest rate changes which are likely to have a material effect on the financial markets and money market instruments.

Thirdly, the penalties for insider trading are perhaps still not sufficiently harsh for deterrence purposes, in spite of the fact that the New Act retained the 10 year imprisonment term and increased the fine to R50 million. Some unscrupulous persons may also evade conviction for insider trading offences by pleading guilty on a lesser offence such as fraud. This was clearly reflected in *S v Western Areas Limited and others*,[12] where, *Western Areas Limited* was unsuccessfully charged with insider trading.

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9 See section 3(1) of the New Act.

10 See generally Barrie G N "Ethics and insider trading in local government: A case of the law and the profits?" (1994) 9 *SAPL* 74.

11 See section 1(b) of the definition of securities.

12 (2004) (4) SA 591 (W) where four accused persons were charged with fraud and contravention of section 424 of the Companies Act 61 of 1973 (the Companies Act), of section 40(c) of the Stock Exchanges Act 1of 1985 and section 2(1) of the 1998 Act. On appeal the accused objected to the indictment on the basis that the charges did not disclose an offence in as much as it is not competent in law to found criminal liability for fraud based on a duty to disclose flowing from the Securities Regulation Panel Rules and the Companies Act, where neither the rules nor the relevant provisions of the Act created criminal liability for non compliance therewith. The court held that, on a proper interpretation of the defence set out in section 4 (1) (d) of the 1998 Act, the conduct of the accused

Fourthly, all the insider trading offences in terms of the New Act are still *rigidly* based on the requirement that a person must know that he has inside information.

Lastly, the New Act fails to resolve the problem of inadequacy of the defences which was one of the major weaknesses of the 1998 Act. This includes the omission of a Chinese Wall defence[13] to protect larger companies from the risk of being liable for insider trading if they have more than one division but have adequate measures in place to prevent improper dissemination of non public inside information between such divisions. The concept of a Chinese Wall defence, its merits and demerits will be discussed in paragraph 4.5 and later Chapters. In essence, the defence entails an operational segregation of functions within an organization and the prevention of inside information from being abused or from flowing freely between departments or divisions.[14]

The mere fact that so many of the issues that were highlighted in Chapter 3 still remain unresolved, may lead to a conclusion that the introduction of the insider trading prohibition in the New Act that consolidates legislation on market abuse practices, is insignificant.[15]

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persons was lawful. See Cassim R "Some Aspects of Insider Trading – Has the Securities Services Act, 36 of 2004 Gone too Far?" (2007) 19 *SA Merc LJ* 44 59.

13 Chinese Wall defences are recognized in *Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)* paragraph 24. They are also provided for in the statutes on insider trading in United States of America and Australia. See the Securities Exchange Commission rules 14e – 3(b)(i)-(ii); the Corporations Act of 2001 sections 1043F and 1043G respectively. Also see generally Van Zyl F H "The European Union directive on insider trading: a model for South Africa?" (1994) 6 *SA Merc LJ* 291-301 and the discussion of Chinese Wall defences by Mwenda K K "Banks and the use of Chinese Walls in managing conflict of duties" (2000) 2 *Web Journal of Current Legal Issues* 14.

14 See Cassim R *op cit* note 12 46.

15 See Jooste R *op cit* note 7 460.

4.2. DEFINITIONS AND CONCEPTS.

4.2.1. Who is an insider?

In terms of section 72 of the New Act, *insider* means "a *person* who has inside information through:

(a)(i) being a director, employee or shareholder of an issuer of securities listed on a regulated market to which the inside information relates; or

(a)(ii) having access to such information by virtue of employment, office or profession; or

(b) where such person knows that the direct or indirect source of the information was a person contemplated in paragraph (a)".

The term "individual" in the 1998 Act was replaced by the term "person" which includes a partnership and any trust and focus in the definition on *persons* as insiders clearly implies the inclusion of juristic persons.[16] In this context the scope of the definition is now wider. The various categories of insiders that are contemplated under the New Act are firstly the *primary insiders* such as the directors, employees or shareholders of an issuer of securities to which the inside information relates that include *fortuitous insiders* or individuals who obtained access to the inside information by virtue of their employment, office or professions. Secondly there are tippees who are *secondary insiders* and the definition now also covers are *juristic* persons. However, as highlighted earlier, the omission of a Chinese Wall defence to protect larger companies from the risk of being liable for insider trading was therefore a serious flaw in the New Act and a major compromise on the part of the legislature.

Furthermore, in agreement with Cassim,[17] the researcher submits that a company which repurchases its own shares is an *insider* to itself. This should be acknowledged to

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16 See section 72. Also see section 2 of the Interpretation Act 33 of 1957.

17 See Cassim F H L "The New Statutory Provisions on Company Share Repurchases: A Critical Analysis" (1999) 116 *SALJ* 760 777.

protect shareholders of a company against such a company taking advantage of non public price-sensitive information to repurchase their shares at a lower price than what the company would have paid if the information had been made public.[18]

4.2.2. What constitutes inside information and the requirement of knowledge thereof?

Inside information is defined as "specific or precise information which has not been made public and which (a) is obtained or learned as an insider, and (b) which if it were made public would be likely to have a material effect on the price or value of any security listed on a regulated market".[19]

Not all information is therefore treated as inside information for purposes of regulating insider trading. Unconfirmed information or rumours are still excluded. As highlighted in the previous Chapter, only accurate and factual non public inside information would fall in the ambit of the definition and information has to meet five requirements to qualify as inside information in terms of the New Act.[20]

Knowledge on the part of the defendant that he *has inside information* is still a prerequisite for criminal and civil liability in terms of sections 73 and 77. This means that the prosecution or the FSB has to prove that the defendant, in addition to having actually dealt in the securities, was aware that his information was in fact inside information. Unfortunately this implies again, that even the slightest degree of ignorance on the part of the defendant is sufficient to enable him to escape liability as was pointed out in the previous Chapter.[21] Moreover, it appears that persons who know that they have non public price-sensitive information and who disclose it inadvertently and by mistake would also be liable, in terms of the New Act.

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18 See Cassim R *op cit* 12 55.

19 See section 72.

20 See paragraph 3.2.3 of Chapter 3.

21 See paragraph 3.4.5 of Chapter 3. It is unfortunate to note that the New Act, just like its predecessor (the 1998 Act) seems almost to encourage persons to abuse price-sensitive information for their own benefit or for the benefit of others on the basis that they can escape liability if knowledge of the inside information cannot be proved. This view is supported by Jooste R *op cit* note 7 442 – 444.

Although it may be argued that the term "know" or "knowing" is self explanatory, its meaning in the context of the provisions is difficult to establish, as is the actual time when a person must have the required knowledge for purposes of the New Act. Therefore it is still possible for a person to practise insider trading and escape liability if it cannot be proved that he has knowledge of the inside information. Provision could have been made, for instance, that once it was established that the accused or defendant was a person mentioned in paragraphs (a)(i) or (ii) of the definition of "insider" in section 72, it will be presumed until the contrary is proved, that the accused knew that the information he had, was inside information and that he had in fact appreciated the price-sensitive nature thereof.

4.2.3. The meaning of "publication".

Inside information seizes to be inside information for purposes of the Act upon its publication. Already published information does not attract any liability unless such publication was not made in terms of the Act.

The term "publication" is not defined and was analyzed in the previous Chapter. Due to an assumption that non public price-sensitive inside information may be ignorantly abused because it is not always easy to establish the exact moment of publication and whether there was timeous publication.[22] The researcher still contends that the provisions of section 74 simply narrate and retain the so-called guidelines for publication that was contained in section 3 of the 1998 Act without actually explaining how such guidelines are to be used to ensure proper and timeous publication. This list of guidelines is still not exhaustive[23] and will not be discussed further in this Chapter.

Perhaps, the New Act should have provided for a *mandatory duty* on insiders to disclose non public price-sensitive inside information in such a way that all stakeholders are given equal access to relevant information and at the same time to minimize the possibility of any unfair advantage to a few selected persons.

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22 See paragraph 3.2.4 of Chapter 3.

23 *Ibid.*

4.3. PROHIBITION OF INSIDER TRADING, CRIMINAL OFFENCES AND PENALTIES.

4.3.1. Prohibition on actual dealing in securities for personal benefit or for any other person.

Actual dealing in securities for *personal benefit* is expressly prohibited in terms of section 73(1)(a) of the New Act. The section provides that an insider who knows that he has inside information and who deals directly or indirectly or through an agent but for his own account, in securities listed on a regulated market to which the inside information relates or which are likely to be affected by it, commits an offence. This section retains with some minor additions and alterations the provisions of section 2(1)(a) of the 1998 Act.

The term "dealing" is not comprehensively defined.[24] It is only stated that the term "deal" includes conveying or giving an instruction to deal.[25] It appears that "dealing" means buying or selling of any listed securities. The New Act should have provided a concise definition of "dealing" to avoid any confusion, manipulation and contravention of section 73(1)(a).

Section 73(1)(a) applies to dealing in securities listed on a *regulated market.* The term *regulated market* refers to "any market whether domestic or foreign which is regulated in terms of the laws of the country in which the market conducts business as a market for dealing in securities listed on that market".[26] The criminal offence of insider trading will therefore only be committed in respect of securities listed on such a market and the prohibition does not cover transactions concluded on unregulated markets, on which the levels of insider trading are allegedly higher.[27] For example unlawful transactions

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[24] See Jooste R *op cit* note 7 445.

[25] See section 72.

[26] See section 72.

[27] See the analysis of the criminal sanction in Chapter 3.

relating to other money market instruments like derivatives are not covered in terms of the New Act.

It is interesting to note that the New Act applies extra-territorially, as was the case with the insider trading prohibitions of the 1998 Act. The Financial Services Board (FSB) has reportedly initiated co-operation agreements with similar authorities such as the Financial Services Authority (FSA) of the United Kingdom and the Securities Exchange Commission (SEC) of the United States of America. Therefore the FSB is inherently empowered to take appropriate steps against any person who allegedly practises insider trading in securities listed on regulated foreign markets.[28]

The provisions of the New Act therefore cover a situation where any person, irrespective of whether he is a South African citizen or domiciled in South Africa, but at a time when he is *physically present in South Africa*, would deal in securities listed on a foreign market or would act through a broker based in another country. Such a person will incur liability under section 73 if he deals on the basis of *any* inside information that he has at the time. In these cases there is a *territorial link* that is established by the physical presence of the insider in South Africa at the time of the transaction. The application of the New Act is however not limited to situations where such a *territorial link* exists.

While this *extra-territorial link* appears to be a sound move for curbing insider trading, it has not been fully utilized due to the lack of adequate resources.[29] From a comparative perspective, one can argue that the legislature should have adopted practical enforcement measures to ensure that insider trading is effectively discouraged in South Africa. It was argued further that the prohibition should only apply to transactions on foreign

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[28] For instance, if a South African resident abuses non public inside information by instructing a broker in New York to make a purchase of any listed securities to avoid liability in South Africa, the FSB could possibly rely on the SEC to detect such illicit trading activity. See Loubser R "Insider Trading and other Market Abuses (Including the effective management of price-sensitive information)" in the *Insider Trading Booklet* final draft 10-18 http://www.jse.co.za 10 October 2006.

[29] See Loubser R *supra* note 28 10-18.

markets where a *territorial link* is present by virtue, either of the fact that the insider is at the time physically present in South Africa, or was acting through an intermediary who is in South Africa or by virtue of the prohibited conduct occurring in South Africa.[30]

Section 73(1)(a) introduces the words "through an agent". Consequently any insider who knowingly practises insider trading through an agent for his personal benefit will now also be guilty of a criminal offence. The extension of the criminal liability to dealing through an agent is a positive development, but it is not clear who exactly may be regarded as an agent for the purposes of this section. A concise definition as distinct from the ordinary meaning for the term "agent" could possibly have minimized the risk of some persons incurring insider trading liability ignorantly.[31]

In terms of section 73(2)(a), any insider who knows that he or she has inside information and who deals directly or indirectly *for any other person* in the securities listed on a regulated market to which such inside information relates or which are likely to be affected by it commits a criminal offence. This section also restates, with a few additions and alterations the provisions of section 2(1)(a) of the 1998 Act. It expressly provides that dealing in securities on behalf of another person is an offence. Unfortunately, the prohibition in terms of section 73(2)(a) is also still limited to securities listed on a regulated market. Furthermore, the absence of the words "through an agent" in section 73(2)(a) clearly shows that the legislature considered them as superfluous but as highlighted above, this could lead to abuse by some unscrupulous persons.

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[30] See Cassim R *op cit* note 12 67. This is also the position in Australia and the United Kingdom - see section 1042B of the Australian Corporations Act of 2001 and section 62 (1) and (2) of the English Criminal Justice Act of 1993.

[31] The New Act should have provided a concise definition of the term "agent" and exclusions of persons who would not be deemed "agents" to avoid any abuse and manipulation of inside information by some persons for their own benefit without incurring liability. See Loubser R *op cit* note 28 26.

The prohibitions on actual dealing in securities for personal benefit or for another therefore still contain a number of uncertainties and one can conclude that many of the flaws of section 2(1)(a) of the 1998 Act have not been removed.

4.3.2. Prohibition on encouraging or discouraging other persons from dealing in securities.

An insider who knows that he has inside information and who encourages or causes another person to deal, or discourages or stops another person from dealing in securities listed on a regulated market to which the information relates or which are likely to be affected by it is liable for a criminal offence in terms of section 73(4). This section substantially adopts the provisions of section 2(1)(b) of the 1998 Act. Section 73(4) also outlaws the practice of *tipping*. Once again the accused must know that he has inside information and it is therefore possible for an accused to plead that he was ignorant of the price-sensitive nature of the inside information at the time when he encouraged or discouraged others to deal in the securities concerned.[32]

However the wording of section 73(4) does not impose any liability on the recipients of such price-sensitive information (tippees). Tippees are insiders in terms of paragraph (b) of the definition of "insider" in section 72, being persons who know that their direct source of the information is a person mentioned in section 72(a). However, even if a tippee trades intentionally on the basis of a tip, he incurs criminal liability only if he knows that the information he has received, is inside information as contemplated in section 73(1) and (2).[33]

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[32] See Jooste R "The Regulation of Insider Trading in South Africa – Another Attempt" (2000) 117 *SALJ* 284 298. Hereinafter Jooste (2000). Also see Jooste R *op cit* note 7 451.

[33] See Cassim R *op cit* note 12 65. Such tippees may escape criminal liability even if they *deliberately* trade in reaction to the tip but do *not* have any *knowledge* of the underlying inside information. The legislature could perhaps have imposed liability on tippees under such circumstances.

4.3.3. Prohibition on disclosure of inside information to other persons.

An insider who knows that he or she has inside information and who discloses such information to another person will be liable for a criminal offence in terms of section 73(3)(a). Apart from a few minor changes, this section resembles section 2(2) of the 1998 Act in many respects.

Like other provisions of the New Act, section 73(3)(a) now extends the liability for improper disclosure of non public price-sensitive information to juristic persons. However, improper disclosure of confidential matters that relate to juristic persons, by their agents is still not adequately covered. An insider in relation to the juristic person may abuse that inside information for personal gain or for the benefit of another person. As pointed out earlier in paragraph 4.2.3, the New Act should have provided for a mandatory duty on issuers to disclose inside information in such a way that all stakeholders are given equal access to relevant information and at the same time to minimize the possibility of any unfair advantage to a few selected persons.[34] The prohibition on improper disclosure of inside information cannot, in the absence of such a duty, be effectively enforced and section 73(3)(a) may easily be contravened without those involved being brought to book.

This is clearly illustrated by the recently alleged insider trading and sale of shares on the basis of improper disclosure of price-sensitive information in relation to Telkom Company Limited. It was reported that the stakeholders in the Elephant Consortium instructed lawyers to unmask all the secret shareholders who controversially purchased a "chunk" of Telkom shares and to investigate whether anyone who purchased any of the shares worth R9 billion would have done so in respect of their own shares. This came amid the fears on the part of some of the stakeholders that the Elephant Consortium might have ceded prematurely, part of its Telkom shares to raise cash.[35] Many uninformed shareholders could have been prejudiced, but in the absence of provisions

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34 See Loubser R *op cit* note 28 10-18.

35 See Simpiwe Piliso "Telkom uproar – dissension in the ranks over the suspected secret sale of shares" *Business Times* 7 24 September 2006.

clarifying the degree of knowledge required and due to the inadequacies and ineffectiveness of section 73(3)(a), the accused persons escaped liability for insider trading. No sufficient evidence could be found against them and consequently, they were never brought before a court of law for their alleged insider trading.

As highlighted in paragraph 4.2.2, section 73(3)(a) also requires knowledge[36] on the part of the person who discloses inside information. Unfortunately it appears that persons who know that they have non public price-sensitive information and who disclose it inadvertently and by mistake would be liable in terms of this section. No provision was made for a defence that these persons may prove, or for them to be charged with other lesser offences. This is seemingly unfair to persons who disclose inside information to others by mistake. However, it must be noted that the JSE listing requirements relating to disclosure of price-sensitive information are specifically formulated to ensure that all stakeholders are given equal access to relevant information in a way that minimizes the possibility of benefiting only a few persons.[37] In terms of section 3.4, a general obligation of disclosure is imposed on all issuers to make a public announcement, through the JSE's Stock Exchange News Service (SENS), of any developments or activities that might result in a material effect on the price of the issuers's listed securities.

Section 3.4(a) states that, except for trading statements, an issuer must, immediately, unless the information is kept confidential for a limited period in terms of paragraph 3.6, release an announcement providing details of any developments in such issuer's activities that are not publicly known and which might lead to material movements of the reference price of such issuer's listed securities. Disclosure of trading statements is dealt with in terms of section 3.4(b). All issuers other than those who publish quarterly

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[36] It appears that mere possession of knowledge is enough to impute criminal liability on any person for contravention of section 73(3)(a). The required degree of knowledge before any person could be held liable for a criminal offence is however not stated. Because of this obscurity some persons who disclose inside information to others could possibly escape liability on the basis that they are ignorant of its price-sensitive nature.

[37] See section 3.27 of the JSE listing requirements.

results must comply with requirements of paragraph 3.4(b)(i) to (vi). Paragraph 3.4(b)(i) states that issuers must publish a trading statement as soon they are satisfied that a reasonable degree of certainty exists that the financial results for a period to be reported upon next will differ by at least 20% from the most recent of the financial results for a previous corresponding period or of a profit forecast previously provided to the market in relation to such a period. Paragraph 3.4(b)(ii) provides that the determination of a reasonable degree of certainty referred above is a judgmental decision taken by the issuer and its directors excluding the JSE. Paragraphs 3.4(b)(iii) to (vi) deal with specific and accurate dissemination of price-sensitive information relating to trading statements by issuers. They also provide procedures that must be followed during and after publication of trading statements.[38]

In terms of paragraph 3.5, price-sensitive confidential information may not, subject to paragraphs 3.6 to 3.8, be released to any third party, an analyst, printer or media during JSE trading hours until it is published in accordance with paragraph 8 of schedule 19 or outside of JSE trading hours until such information has been authenticated or proved in accordance with paragraphs 6 and 7 of schedule 19 and arrangements have been made before the next business day's opening of JSE trading hours. Price-sensitive information may, in the strictest confidence, be disclosed in terms of paragraphs 3.6 to 3.8 to persons such as government departments, South Africa Reserve Bank, SRP, FSB, investment analysts or any other statutory or regulatory body and may not be published unless there is a breach of confidentiality and the market is made aware of such information.

Disclosure of cautionary announcements and periodic financial information by issuers are provided for in paragraphs 3.9 and 3.11 respectively. Issuers may also give similar announcements and reports in terms of paragraphs 3.12 to 3.22. Issuers who fail to comply with these disclosure requirements, particularly to disclose annual financial statements, may risk suspension or possible termination or delay of their securities from the JSE in terms of paragraph 3.23. Issuers must, by way of notice and in writing inform the JSE immediately of any proportion of listed securities in the hands of the public

[38] See also paragraphs 3.4(b)(vii) to (viii).

which might have been affected or fallen below shareholder spread requirements in accordance with paragraphs 3.42 and 3.43. They must also disclose all relevant information in terms of paragraph 3.44 to holders of securities, to enable them to exercise their rights. Furthermore, paragraphs 3.63(a) and (b) state that issuers must disclose all the details of their transactions in securities relating to the issuer by or on behalf of the director, company secretary, any associate of the issuer or any independent entity, if such issuer may derive a beneficial interest.[39]

4.3.4. Criminal liability and penalties.

The criminal sanctions for insider trading and related market manipulative practices such as tipping have been increased. Persons who contravene section 73 and fail to rely on any available defences may in terms of section 115, be sentenced to a fine not exceeding R50 million or imprisonment for a period not exceeding 10 years or both. The legislature raised the fine significantly from R2 million to R50 million. While this appears to be significant, it is submitted that standing alone, even the R50 million fine and a 10 years imprisonment term cannot be an effective deterrent. It is still possible that prospects of enormous profits may outweigh the deterring effect of the fine or prison sentence.

The fact that the actual perpetrators may plead guilty and be convicted of lesser offences also has a negative effect on any impact a criminal sanction might have. Consequently, very few successful prosecutions for insider trading have been recorded and this is unlikely to be different in future.

[39] See also paragraph 3.83.

4.4. CIVIL LIABILITY IN TERMS OF THE NEW ACT.[40]

In addition to the provisions that impose criminal liability on those who were involved in insider trading activities, section 77 of the New Act like its predecessor also provides for civil liability. At a glance, it appears as if section 77 corrected some of the flaws left in section 6 of the 1998 Act, but its provisions are still grossly inadequate and ineffective.

Section 77(1) imposes civil liability on an insider who knows that he has inside information and who deals directly or indirectly or through an agent for his own account in securities listed on a regulated market to which the information relates or which are likely to be affected by it and who makes profit or would have made a profit if he had sold the securities at any stage, or avoids a loss through such dealing unless he proves one of the defences set out in section 73(1)(b). Such a person is then liable at the suit of the FSB in any court of competent jurisdiction, for the amounts as stipulated in section 77 (1).

This provision imposes liability on persons who practise insider trading for their personal benefit. One of the notable changes brought about by section 77(1)(a), is the introduction of the term "through an agent" to cover the situation where a principal (the insider) deals in securities through another person as his agent.[41] However it may not seem logical to include such a term since the principal-agent transactions are already covered by the term "indirectly".[42] For instance, situations where an insider deals in

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[40] Chesterton G K once said "Thieves respect property, they merely wish the property to become their property so that they may more perfectly respect it". This statement attempts to explain why some persons practise insider trading to the detriment of other innocent investors. See Loubser R *op cit* note 28 19 for a full discussion of this quotation and the sanctions for insider trading.

[41] See Loubser R *supra* note 28.

[42] The New Act did not define the term "indirectly" but according to the *Oxford English Dictionary Online*, it is defined to mean an indirect action, means, connection, agency or instrumentality through some intervening person or thing, mediately. Assuming this definition is adopted it would appear that section 77(1)(a) prohibits indirect insider dealing in securities through a nominee as well as through an agent. See Whiting A "Civil liability for insider trading: A comparison of the Insider Trading Act of

securities through a nominee[43] may fall in ambit of both "indirect dealing" as well as dealing "through an agent". It is submitted that this ambiguity could weaken this provision.

Instances where an insider practises insider trading and makes a profit or avoids a loss for personal benefit or for the benefit of any other person are now prohibited in terms of section 77(1)(b). This is probably aimed at stopping insiders from avoiding liability on the basis that they would not actually have dealt in the securities in question, hence they would in the first instance, not have profited or avoided losses in any event.

In terms of section 77(1)(c), the person involved will be liable to pay the FSB an equivalent to the profit made or loss avoided or as a penalty for compensatory and punitive purposes, an amount as determined by a competent court[44] but not exceeding three times the amount of the profit made or loss avoided plus interest and legal costs as determined by the court. The prejudiced persons who prove their claims in terms of the Act will only get their compensation after the FSB has recouped its costs and expenses in relation to the successful litigation.[45]

Section 77(2) of the New Act imposes liability on an insider who abuses price-sensitive inside information by dealing directly or indirectly for another person, in securities listed on a regulated market to which that inside information relates or which are likely to be affected by it and who makes profit or would have made profit for that other person or avoids a loss through such dealing. Seemingly, like many other provisions of the New Act, it fails to adequately provide guidelines to establish when dealing is "likely" to have a material effect on securities listed on a regulated market.[46]

1998 with the Securities Services Act of 2004" (2005) *Responsa Meridiana* 99 106-110. Also see Jooste R *op cit* note 7 450; Cassim R *op cit* note 12 58 and comments in note 31.

43 See the definition of a "nominee" in section 1.

44 These are the High Courts and regional courts - see section 79.

45 See Whiting A *op cit* note 42 116-117.

46 The New Act should have defined the term "likely" to avoid any ambiguity which may enable persons to evade civil liability. See also Jooste (2000) *op cit* note 32 300.

Section 77(2) is further subject to section 77(5). Section 77(5) provides that "if the other person referred to in subsections (2), (3) and (4) is liable as an insider in terms of subsection (1), the insider referred to in subsections (2), (3) and (4) is jointly and severally liable together with that other person to pay the amounts set out in subsection (2) (i), (iii) and (v), (3) (i), (iii) and (v), or (4)(a), (c) and (d), as the case may be". Therefore this joint and several liability is contingent upon a tippee's liability as an insider. It appears that that there will be no liability for a party, who for instance deals in the securities in question but is not an insider as contemplated in section 72.[47]

Section 77(3) imposes civil liability on an insider who knows that he has price-sensitive inside information, for *improper disclosure* of such information to other persons. However as discussed earlier, incidences of contravention of this section can be reduced if provision is made for mandatory and timeous disclosure of the information to ensure that all interested persons are given equal access to it. The Act does not, for instance provide how companies can lawfully disclose price-sensitive inside information to relevant persons such as investment analysts so that they would not be practising or falling victims to insider trading.[48]

Lastly, section 77(4) imposes liability on an insider who encourages or causes another person *by tipping* to deal in securities listed on regulated markets. Discouragement of others from dealing in securities by a person who knows that he has inside information, is omitted from this subsection. A person who discourages another from dealing will therefore not incur any civil liability although he may be guilty of an offence in terms of section 73(4).[49] Any person who deals in securities on the basis of the advice is not

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47 See Jooste R *op cit* note 7 454 – 455.

48 In some instances discussions between company executives and investment analysts may give rise to insider trading. Although the Johannesburg Securities Exchange introduced additional listing requirements in an attempt to reinforce the prevention of improper disclosure of inside information, they are yet to make a significant contribution due poor implementation by companies. See Loubser R *op cit* note 28 14 – 16. It must be noted however that this research is limited to the statutory dispensation excluding the listing requirements of the JSE

49 See Jooste R *op cit* note 7 455.

necessarily an insider and only incurs liability in terms of section 77(1) or (2) if the information has in fact been communicated to him. It should be noted that no provision is made for any defences in relation to sections 73(4) and 77(4).

4.5. DEFENCES AND ADEQUACY THEREOF.

A critical evaluation of the adequacy of the defences provided for in the New Act is also necessary.

Firstly, any person charged with insider trading for his own benefit may escape liability if he proves on a balance of probabilities that:

- he was acting in pursuit of the completion of an affected transaction as defined in section 440A of the Companies Act, 61 of 1973; or
- he became an insider after having given the instruction to deal, to an authorised user and such instruction was not changed in any manner after he has become insider.[50]

The first mentioned defence could have given rise to abuse by unscrupulous insiders in relation to the offeror or offeree company through dealing in securities of the affected companies at an early stage of the negotiations.[51] The Securities Regulation Panel Rules (SRP) pertaining to disclosure of price-sensitive information are aimed at reducing abuse in this respect. In terms of the General Principles, all parties to an offer relating to an affected transaction are obliged to take all reasonable steps to prevent the making of misleading statements and creation of false markets, and directors of the offeror and the offeree companies are under a duty to disregard their own interests and those of their families when giving advice to holders of securities.[52] Before the announcement of an intention to make such an offer, secrecy shall be observed by all persons who are privy to confidential information, whether price-sensitive or otherwise and all persons

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50 Section 73(1)(b) of the New Act.

51 See *S v Western Areas Limited and others* (2004) *supra* note 12 606.

52 See respectively General Principles 6 and 9.

concerned must take all reasonable steps to minimize the prospects of such information being leaked accidentally.[53]

Whenever an offeree company is subject to rumours or speculation or there are abnormal movements in the price of its securities or the volume of such securities traded on the JSE, or whenever the negotiations are extended to include more than a very restricted number of persons other than those in the company, a cautionary announcement shall be made.[54] An announcement of a firm intention to make an offer is required to be made when the board of the offeree company receives notice of such intention or when an obligation arises to make a mandatory offer under Rule 8 because the specified percentages of securities have been acquired by the offeror as stated in Rule 2.3.1. Rule 2.4 states that these announcements shall be published in daily newspapers circulating in Johannesburg and any other regions, where registered offices of the parties are, as well as to Reuters, the South African Press Association and the JSE. Rules 16.1 and 16.4 stipulates further that all shareholders are entitled to equal access to information as nearly as possible at the same time and in the same manner. Rule 4 provides that during an offer period, the offeror or a mandatory offeror under Rule 8 and persons acting in concert with it may not sell any securities except after the prior consent of the SRP and after 24 hours' public notice as prescribed in Rule 7.1. Rule 7.1 requires notice to the SRP, further notice by way of a press release and if the company is a listed company, also to the JSE. Similar notice is required in terms of Rule 7.2 if the transaction is concluded on behalf of a client. Immediate announcement of any amendments to the terms of the mandatory offer is required in terms of Rule 8.

Secondly, persons who allegedly abused inside information directly or indirectly by dealing in securities on behalf of other persons will be exempted from liability if they prove on a balance of probabilities any of the defences provided for in terms of section 73(2)(b). These defences are the following:

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[53] Rule 2.1. News releases may only take place with the prior approval of the SRP.

[54] Rule 2.2.2.

- the accused or defendant is an authorised user[55] and was acting on specific instructions from a client, save where the inside information was disclosed to him by that client; or
- the accused or defendant was acting on behalf of a public sector body in pursuit of monetary policy, policies in respect of exchange rates, management of public debt or external reserves.

However, the latter of these defences is also prone to manipulation and abuse by persons who work in government and semi-government departments. Securities or bonds of the public sector are furthermore, not necessarily listed on regulated markets and consequently insider trading in these instruments does not lead to any liability at all.

Thirdly, the defendants or persons accused of improper disclosure of price-sensitive information to other persons may avoid liability by proving on a balance of probabilities any of the defences provided for in terms of section 73(3)(b). These include that:

- such disclosure was necessary for purposes of proper performance of the functions of their employment; or
- office; or
- profession in circumstances *unrelated to dealing in any security listed* on a regulated market and that the accused or defendant at the same time disclosed that the information was inside information.

However the inherent subjective nature of this defence seems to suggest that the same problems may be encountered under the New Act as were found in section 4(1)(b) of the 1998 Act. Persons who disclose price-sensitive information to others may abuse this defence and escape liability by merely showing that they *believed* that such disclosure

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[55] An authorised user is a person authorised by an exchange in terms of exchange rules to perform such securities services as the exchange rules may permit for example brokers or any other person permitted to perform these services by the Registrar of Securities Services in terms of the Act. See sections 1, 18 and 19.

was necessary for *proper performance* of their duties. Perhaps, as discussed earlier, more specific provisions relating to mandatory disclosure of price-sensitive inside information in relation to listed securities should at least offer a partial solution to this problem. For instance, where a company has issued a cautionary or trade update notice, a broker or an intermediary acting in good faith should be allowed to advise on his interpretation thereof, provided he does not disclose any other information he might have received from other sources.[56]

Fourthly, the New Act omitted to include Chinese Wall defences to protect bigger companies having adequate measures in place to avoid the flow of, and manipulation of inside information between its different divisions. The Chinese Wall defence essentially entails the creation within a multi-functioning organisation, of a physical and an operational segregation of functions to prevent the flow of price-sensitive inside information from one department to another. A bank or a multi-financial services company may for instance put in place such barriers to prevent the flow of information from its *investment banking department* which in the course of its activities gets non public price-sensitive information from its corporate clients, to its *retail brokers section* which makes trade recommendations to investor customers.[57] If such an arrangement is put in place in an organisation *and* is operating effectively, it should constitute a defence to any allegation of insider trading against that organisation.

Cassim submits that the disadvantages of a Chinese Wall defence outweigh its advantages and that it should not be introduced in South Africa. She argues that juristic persons can be adequately protected if the legislature imposes a mandatory duty on them to make prompt and full disclosure of all material non public price-sensitive information

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[56] Moreover, if the prohibition on insider trading is to be extended to *unlisted securities* or *financial instruments*, companies should again be obliged to keep registers of insiders, their interests and dealings in respect of such interests as was previously provided for in sections 230-232 of the Companies Act 61 of 1973.

[57] See Cassim R *op cit* note 12 46-47. Also see Chapters 5 and 7 for statutory provision for such a defence in other jurisdictions.

at their disposal,[58] and banks, financial service companies and brokers should maintain a restricted list of securities whenever they are entrusted with non public price-sensitive information about customers.[59] Although the researcher supports the proposal for prompt disclosure of inside information[60] and is not opposed to the introduction of a restricted list of securities, it is submitted that these measures do not render a Chinese Wall defence superfluous.

Basically Cassim's objections to a Chinese Wall defence are the following:

- Its effectiveness will inevitably decrease and it will be extremely difficult to monitor.[61] However, the mere introduction of a Chinese Wall defence without effectively managing it, will certainly not constitute a defence for juristic persons. Furthermore, the submission that it would not be effective in smaller firms is contradicted by the case of *Rakusen v Ellis Munday and Clark*[62] quoted by Cassim herself, even though it was considered to be an uncommon arrangement where each "partner" kept his part of the business separate from the other's.

- A Chinese Wall defence, even if it is effectively in operation so that it could *reasonably be expected to ensure*[63] that inside information would not be communicated, will not prevent internal disclosure of inside information, whether by accident or by unscrupulous employees.[64] Its effectiveness would therefore depend entirely on the integrity of management, the honour system and the ethical values of those involved.[65] It should however be noted that a

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58 See Cassim R *op cit* note 12 53.

59 See Cassim R *op cit* note 12 54.

60 See paragraph 4.3.3 above.

61 See Cassim R *op cit* note 12 50-51.

62 [1912] 1 Ch 831 (CA).

63 As is required in terms of the Australian and American statutory provisions quoted by Cassim R *op cit* note 12 48-49. These provisions will be discussed in Chapters 5 and 7.

64 See Cassim R *op cit* note 12 51.

65 *Ibid.*

Chinese Wall defence is intended to be available to a juristic person that has admittedly put it in place as a precautionary measure[66] and not to discourage insider trading as such.[67] Moreover, this defence is available to juristic persons only. Employees and members of management who disclose information or otherwise contravene the provisions of the Act will still incur liability. Therefore juristic persons would probably be encouraged, by the mere fact that provision is made for such a defence, to put it in place and rigorously monitor their own internal regulatory framework as was previously advocated by the researcher.

- The organisation may lose out on advantages that might be gained from collective thinking.[68] It is however not intended to make this arrangement compulsory and any organisation may decide for itself, whether to put it in place or not.

- A Chinese Wall defence may compromise fiduciary duties in the sense that clients may deal in securities to their disadvantage because the broker-dealer section was not allowed to advise them on the basis of non public inside information that was available to another department.[69] It should however be noted that the mere fact that disclosure of inside information is prohibited in the first instance, means that such clients are in any event statutorily precluded from having any access to that information until it is made public. It would therefore *not* be wrongful to withhold the information from clients and clients would not have had any right of action against that organisation in the first instance.

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66 See Cassim R *op cit* note 12 46-47.

67 That is the purpose of the prohibition itself.

68 See Cassim R *op cit* note 12 51-52.

69 See Cassim R *op cit* note 12 52-53.

4.6. ENFORCEMENT OF THE INSIDER TRADING PROVISIONS.

4.6.1. The role of the Financial Services Board (FSB).

The FSB has ostensibly wide powers to ensure proper supervision and enforcement of the prohibition on insider trading and other market related manipulative practices in terms of section 82(1). This section resembles section 11 of the 1998 Act which dealt with same functions of the FSB.[70]

In terms of section 82(2), the FSB may investigate any matter relating to insider trading, and subject to section 83, summon any suspected person to furnish relevant information on the subject matter of any investigation, interrogate persons, search and seize any property which is believed to be of help in its investigations, administer proof of claims and distribute payments of claims, to make market abuse rules after consultation with the Directorate for Market Abuse (DMA) and after consultation with the relevant markets in South Africa, require such markets to implement such systems as are necessary for effective monitoring and identification of insider trading and related market abuses.[71]

The FSB has limited authority in relation to the prosecution and settlement of insider trading cases except where a matter is settled out of court. The actual profit made or loss avoided in civil matters is determined by competent courts.[72] The FSB may itself prosecute criminal cases relating to insider trading, only if the Director of Public Prosecutions (DPP) declines to prosecute them.[73] Moreover, the backlog that characterizes our courts is well known, and this has grossly impeded the effective enforcement of the criminal sanction in relation to insider trading in South Africa.

It has been stated that the FSB is staffed with persons who have forensic and prosecutorial skills as well as relevant expertise in relation to financial markets.

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70 The FSB is an independent board established in terms of Financial Services Board Act, 97 of 1990.

71 See section 82(2)(a) - (h).

72 See section 79.

73 See section 82(9); Barrow R "Insider Trading Directorate" *Business Report* 28 July 2004 and Chanetsa B "Insider is notoriously hard to prosecute" *Business Report* 26 April 2004.

Furthermore, it has also been stated that the FSB has sufficient sophisticated equipment in place to detect any suspected illegal trading and to provide the details of the beneficial owners of securities held in nominee accounts.[74] In spite of this, however, very few cases of successful prosecutions have been recorded. This suggests that these statements might not reflect the true situation in relation to the staffing and resources of the FSB. If the FSB has such good infrastructure and expertise, more cases should have been reported. An institution such as the FSB should be adequately resourced to fulfill its functions and care should be taken that its effectiveness is not undermined by bureaucracy.

It is generally submitted that interrogations[75] of persons and search of premises[76] is only possible upon application by the board, to a judge or magistrate who has jurisdiction in the area where the premises in question are located.[77] This implies that not all persons will be timeously summoned by the FSB. Perhaps, the FSB should have more offices in different regions of South Africa to increase awareness[78] and to function more effectively.

4.6.2. The role of the Directorate for Market Abuse (DMA).

The Directorate for Market Abuse is established as a committee of the FSB in terms of section 83(1)(b). It is interesting to note that apart from the changing of the name of the Insider Trading Directorate to Directorate for Market Abuse (DMA), this provision resembles section 12 of 1998 Act in several respects.

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74 See Barrow R *supra* note 73.

75 See section 82(2)(e).

76 See section 82(2)(f).

77 See section 82(3)(a); Cokayne R "Setback for South Africa's first insider trading case" *Business Report* 28 April 2004.

78 Although the FSB is entitled to publish notices of any insider trading or related market abuses in terms of section 82(5) to increase awareness, it is has failed to implement this provision successfully due to suspected inadequate availability of resources.

The DMA is made up of representatives of the regulated markets, the Share Holders' Association of South Africa, the fund management industry, the insurance industry, the Reserve Bank of South Africa, the bankers, the accounting and legal professions. These persons are appointed by the Minister of Finance[79] on the basis of their availability, expertise and knowledge of financial markets.[80]

The powers and functions which the DMA may exercise and perform on behalf of the FSB are set out in section 83(1)(c) of the New Act. It is empowered to institute any civil proceedings as contemplated in the Act and to investigate any matter relating to insider trading or other market abuses. If it produces appropriate warrant, it has the powers to summon, interrogate and to search and seize any documents in possession of suspected persons.[81]

The DMA does not operate in isolation. It is submitted that it may also investigate any suspected insider trading cases forwarded to it by the Johannesburg Securities Exchange's Surveillance Division. The New Act could have provided for, that the JSE's Surveillance Division is statutorily obliged to report any suspected insider trading activity to the DMA. It can be noted that even at the present stage, not a single person has been convicted in a criminal case although a few settlements with the FSB in civil cases are pending.[82]

Furthermore the DMA may decide whether to refer a matter to the Enforcement Committee or to institute civil proceedings or to refer a matter to the prosecuting authorities (DPP) on behalf of the FSB. For instance, "it may only institute civil proceedings in the name of the FSB and may settle any matter only after confirmation from the FSB or a competent court". The DMA therefore only exercises specific powers

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79 See section 83(3)(a)-(j).

80 See section 83(4).

81 See generally section 83(1)(c) read with section 82(2).

82 Nineteen cases of insider trading were investigated by the DMA between November 2004 and April 2007. Three of these cases were abandoned (closed) and the remaining sixteen are still pending. Perhaps this shows that the DMA is not performing its functions effectively. See the Directorate for Market Abuse Report *Media Release* http://www.fsb.co.za 13 June 2007.

in the name of the FSB and does not have extended powers that it may exercise in its own name.

4.6.3. Effectiveness of the current enforcement mechanism.

The success of any piece of legislation is usually determined by the adequate and effective enforcement of its provisions. It is against this background that it has to be examined whether the provisions of the New Act are adequate to effectively combat insider trading in South Africa. This includes an incisive analysis into the effectiveness of the courts, FSB, Enforcement Committee (EC) and the DMA as enforcing mechanisms.

Firstly, the New Act expressly imposes the responsibility of enforcing and monitoring of the insider trading provisions on the FSB in terms of section 82. As discussed earlier in paragraph 4.6.1, the FSB is failing to effectively enforce the insider trading provisions in many ways. Moreover, the New Act does not provide for *a right of action* for affected persons who can afford the legal costs. Although it can be argued that it is cheaper to claim compensation through the FSB, it can, on the contrary, also be said that these flaws have *deterred* many persons from claiming their damages through the FSB because of fears that such a strategy would not produce any results.

Secondly, the DMA has also not produced the desired results.[83] This is possibly because of its limited authority (powers). It does not carry out any duty without confirmation from the FSB and the courts.[84] Despite submissions by Rob Barrow,[85] that the DMA has sufficient sophisticated equipment and competent personnel to ensure effective enforcement of insider trading provisions, the few prosecutions and settlements suggest otherwise.

Thirdly, the EC was established in terms of section 97 in an attempt to improve the enforcement of insider trading and other related market abuses. Unfortunately, it also

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83 See paragraph 4.6.2.

84 See sections 78 and 83(1)(c).

85 See Barrow R *op cit* note 73.

has limited powers in the execution of its functions. For instance, it may only institute civil proceedings in a court of law against any person who violates sections 73 and 77 on a referral basis[86] and where no compensation was paid by the defendant in terms of section 77.[87] This has weakened the effectiveness of the EC. No cases of insider trading have been successfully settled with the EC up to date.

Lastly, the courts are empowered to deal with any matter relating to insider trading or other related market abuses in terms of section 79. This implies that the prosecutorial powers of insider trading cases lie with the DPP. The work load and pressure on the DPP might well be the reason for the absence of prosecutions. Many cases of insider trading may well be abandoned because of the back-log in the courts. The introduction of separate courts manned with specialists to deal with insider trading matters should enhance effective enforcement of the Act and should receive serious consideration.

In a nutshell, the current enforcement mechanism is inadequate and ineffective. There is an urgent need to introduce more effective practical measures to ensure effective and speedy enforcement of insider trading legislation in South Africa.

4.7. CONCLUDING REMARKS.

There can be no doubt that the New Act is a result of an attempt to adequately resolve some of the flaws that were evident in its predecessor. Notable examples of such attempts are:

- inclusion of a juristic person's liability,
- increase of the fine for insider trading activities from R2 million to R50 million and
- introduction of the Enforcement Committee (EC).

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86 See section 101(2).

87 See section 105(5).

Problems that were previously experienced are however, still not adequately addressed. The legislature inconsistently dealt with a few concerns that were raised against the 1998 Act and in the process it has introduced more problems. The criminal penalties for insider trading are for instance *still inadequate* for deterrent purposes.[88] Furthermore, the establishment of additional structures such as the EC to resolve the problems relating to enforcement of insider trading legislation did not produce the desired results.[89]

One of the major flaws of the New Act is that its application is limited to insider trading activity in respect of *securities* listed on a regulated market.[90] This also implies that other *money market instruments* that are not necessarily listed securities, are excluded from the auspices of the insider trading provisions and that any insider trading activity that is allegedly rife in unregulated markets is not covered.

The right to claim compensation is still exclusively given to the FSB and no provision is made for affected persons to claim directly from perpetrators.[91] This rigid approach can easily result in a failure to effectively compensate many affected persons. Affected persons must have a right to claim compensation from any person who is convicted of insider trading directly if the FSB does not institute such proceedings timeously.

The absence of a rigorous mandatory disclosure mechanism and of a duty imposed on companies and other relevant institutions to disclose price-sensitive information about listed securities and financial instruments that frequently comes into their possession is another loophole in the New Act. This may lead to a host of problems, for example untimely disclosure of information, inaccurate information in relation to prices of listed securities and manipulation by unscrupulous persons who may make enormous profits.[92] The New Act should have introduced mandatory disclosure or reporting measures to

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88 See section 115(a).

89 See *supra* note 83 and the commentary in paragraph 4.6.3.

90 See section 3(2)(a) and (b) and Jooste R *op cit* note 7 451. Also see the discussion in paragraph 4.1.

91 See section 82(2)(c).

92 See Osode P C "The New Insider Trading Act: Sound Law Reform or Legislative Overkill?" (2000) 44 *Journal of African Law* 239.

require reporting through the Stock Exchange News Service and in the media as required in terms of SRP Rule 2.4

Because a criminal sanction will *on its own* never be an effective deterrent, consideration should be given, perhaps to other appropriate sanctions such as forfeiture or cancellation of business licences, professional accreditation or registration of financial advisors and disqualification for life of directors. This may deter many more persons from practising insider trading.

Lastly, in addition to the inadequacies relating to enforcement, the New Act contains a number of inconsistencies and ambiguities that lead to uncertainties that were highlighted in this Chapter. Another undermining factor is the prospect of reaching a settlement with the FSB without admitting liability.[93]

It is therefore submitted that the current regulatory framework is still inadequate and ineffective for purposes of combating insider trading in South Africa.

[93] See Simpiwe Piliso *op cit* note 35 7 and the discussion in paragraph 4.3.2.

CHAPTER FIVE

THE REGULATION OF INSIDER TRADING IN UNITED STATES OF AMERICA: A COMPARATIVE PERSPECTIVE.

5.1. INTRODUCTION.

The United States of America (US) insider trading regulatory framework is arguably the one that was the most adopted and *preferred* by other countries.[1] South Africa is no exception. Therefore in this Chapter, a comparative analysis of the regulatory frameworks in these two countries will be carried out.

Furthermore, this Chapter will examine whether integration of the US insider trading principles into the South African regulatory framework has worsened or improved the regulation of insider trading in South Africa.[2] Therefore relevant US provisions and cases will be examined and where necessary contrasted with similar cases and provisions in South Africa.

5.2. REGULATORY FRAMEWORK REGARDING INSIDER TRADING IN THE UNITED STATES OF AMERICA.

Firstly, a general overview of the development of insider trading legislation in the US is necessary and thereafter a comparison with developments in South Africa will be made. The securities regulation of insider trading in the US at a federal level was introduced by the Securities Exchange Act of 1934 (the 1934 Act).[3] Before the 1934 Act, cases dealing with insider trading were decided on the basis of existing common law and often failed to

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1 For instance Japan and China expressly follow the US principles. See Steinberg M I "Insider Trading – A Comparative Perspective" (2002) http://www.sec.gov 20 12 October 2006.

2 See generally Botha D "Control of Insider Trading in South Africa: A Comparative Analysis" (1991) 3 *South African Mercantile Law Journal* 1-18 1.

3 See section 16(a) and (b) as well as section 10(b).

successfully deal with the issue in question. In *Godwin v Agassiz*[4] the Supreme Court denied relief to the plaintiff who had sold his own shares to his detriment after having read a newspaper report stating that the company had stopped operating. He was unaware of the fact that directors were buying and selling shares on the basis of non public information at their disposal because these transactions were *anonymously* conducted through the Stock Exchange.

However the 1934 Act was deficient in several respects, for example section 16(a)[5] failed to adequately empower the United States Securities and Exchange Commission[6] to recover profits that were illegally obtained by those who practised insider trading. This function was merely left to a company's own managers, directors and shareholders. In an attempt to resolve this problem, the United States Securities and Exchange Commission (SEC) introduced a number of anti-fraud provisions through Rule 10b-5 but they nonetheless remained inadequate. Rule 14e-3 was further enacted to correct these flaws, but it was also unsuccessful.[7]

The Congress at the request of SEC enacted the Insider Trading Sanctions Act of 1984 (the 1984 Act).[8] This Act empowered the SEC to order anyone who practised insider trading through *tipping* or otherwise to pay an amount of up to three times the profit made or loss avoided for the benefit of all persons who were prejudiced by it.[9] Unfortunately, the 1984 Act failed to provide an adequate solution to the regulatory problems in the US.

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4 (Mass 1933) 186 NE 659.

5 See paragraph 5.2.2 of this Chapter.

6 This body was established in 1934 as an independent board to enforce the insider trading prohibition in the United States of America.

7 See Arshadi N and Eyssell T H *The Law and Finance of Corporate Insider Trading: Theory and Evidence* Kluwer Academic Publishers 1993 46.

8 Public Law 98-376.

9 See paragraphs 5.2.4 and 5.2.6 of this Chapter.

In an attempt to have a more adequate insider trading legislation, the Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (the 1988 Act).[10] This Act introduced numerous changes to the regulation of insider trading in the US. For instance, it stipulated that public companies should adopt adequate policies to monitor and discourage their employees from practising insider trading.[11] However, many of these persons were still able to contravene the provisions of this Act. The *Enron* scandal is a glaring example. As a result of poor auditing and insider trading activities on the part of directors the company's net income was reduced by $600 million and its debt increased to about $628 million.[12] In response to these accounting and corporate scandals the Congress enacted the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act).[13] This Act introduced a new stringent regulatory structure for accounting companies and professionals to discourage *inter alia* illicit practices such as insider trading.[14]

In contrast to the early developments of the regulation of insider trading in the US, the legislature in South Africa only introduced a prohibition on insider trading in terms of section 233 of the Companies Act, 61 of 1973.[15] It however borrowed blindly, many principles from the US regulatory framework as will be discussed later.

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[10] Public Law 100-704, 102 Stat 4677 (19 November 1988).

[11] Arshadi N and Eyssell T H *supra* note 7 51.

[12] See Palmiter A R *Securities Regulation: Examples and Explanations* 3rd ed Aspen Publishers New York 2005 24.

[13] See Palmiter A R *op cit* note 12 23.

[14] The Sarbanes-Oxley Act will be referred to only where necessary. There are also other separate Acts that specifically regulate insider trading such as the Racketeer Influenced and Corrupt Organization Act of 1970 (RICO) that will not be discussed for purposes of this dissertation. This Chapter discusses mainly the US federal statutes on insider trading.

[15] See the historical development of the regulation of insider trading in Chapter 2 of this dissertation.

5.2.1. The scope and meaning of "insider trading".

Unfortunately insider trading is not statutorily defined in the US legislation. The discretion to decide what constitutes insider trading was left to the federal courts and the SEC.[16] However, neither the federal courts nor the SEC defined the concept. Key terms and concepts relating to the insider trading offence are also not defined in the statutes, for instance terms such as "inside information", "insider", "tippee" and "illegal insider trading".[17]

Although the South African regulatory framework has attempted to comprehensively define some of the relevant terms in section 72 of the Securities Services Act, 36 of 2004,[18] it appears to have followed the US approach and did not attempt to define the fundamental concept of insider trading. Consequently some of the flaws that characterise the US regulatory framework are also found in South Africa. It is therefore clear that this non-codification approach of the US should not have been adopted in South Africa.

5.2.2. The prohibition on "insider trading".

The similarities and differences in the provisions of the US and South African legislation that prohibits insider trading will be briefly examined here. The 1934 Act directly prohibited insider trading in the US in section 16(b)[19] and indirectly in section 10(b).[20] However section 16(b) applied only to directors or officers of a company who held more

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16 See Steinberg M I *op cit* note 1 16.

17 See Steinberg M I *supra* note 1 16-17. Also see generally Nasser "The Morality of Insider Trading in the United States and Abroad" (1999) 52 *Okla L Rev* 377-385.

18 Hereinafter referred to as the "New Act".

19 Section 16(b) prohibited short-swing profits (profits obtained in less than 6 months) by corporate insiders in the corporation's stock except when it was in the best interests of that corporation or its shareholders.

20 Section 10(b) prohibited any person to use or to employ in the purchase or sale of any securities registered on a securities exchange or any unregistered securities, a deceptive device for the purpose of contravening any rules and regulations of the SEC.

than a 10 percent stake in the company. Section 16(a) provided a mandatory disclosure requirement for such insiders. They had to file with the SEC any transactions amounting to insider trading within ten days after they were concluded. These provisions did not apply to other persons, for instance tippees.

Due to the inadequacies of these provisions, the SEC adopted rule 10b-5 which broadly speaking, prohibited fraud or misrepresentation by *any person* in relation to the purchase or sale of any securities. It is interesting to note that neither section 10(b) nor Rule 10b-5 specifically prohibited trading by insiders while in possession of non public inside information. A prohibition on insider trading was contingent upon the interpretation of the courts.[21] However, it is clear that non disclosure by an insider of material facts that were not known to the other party during the negotiations, would amount to a misrepresentation.

In an attempt to solve this inadequacy the Congress enacted section 14(e) and the SEC adopted Rule 14e-3 which, however, applied only in tender offer situations.[22] Rule 14e-3 prohibited "*any person who has obtained directly or indirectly, material confidential information*" regarding a tender offer from the offeror (bidder), target company or an intermediary, to *trade or tip* another person to trade in that offer before making an adequate public disclosure of such information. Furthermore, a tippee who knew or should have known that such information had come from an insider was also prohibited from trading with it until an adequate public disclosure was made. Rule14e-3 applied to all persons (even juristic persons) but nonetheless it was not enforced in practice.

The inherent inadequacy of the 1934 Act led the Congress to adopt the 1984 Act. This Act introduced section 21A empowering the courts to impose a criminal penalty on any person who violated the insider trading provisions. Unfortunately, it failed to solve the

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21 As articulated *In the Matter of Cady, Roberts and Company* [1961-1964 Transfer Binder] CCH *Fed Sec L Rep* 76. 803 81. 016 and also *Chiarella v United States* (1980) 445 US 222-230.

22 See Gaillard E (ed) *Insider Trading: The Laws of Europe, the United States and Japan* Kluwer Law and Taxation Publishers Netherlands 1992 296.

inadequacy problem because its provisions applied only to a few persons and the Congress further enacted the 1988 Act. This Act amended section 21A and imposed liability on "controlling persons"[23] for insider trading activities of their employees. However, it appears that this Act was still flawed and inadequate, hence the SEC and the Congress were forced back to the drawing board.

Recently, the SEC adopted Rule 100 and Regulation Fair Disclosure (FD)[24] which prohibits companies from selectively disclosing material non public information to market professionals and favoured shareholders. The SEC further adopted Rule 10b5-1 in another attempt to combat insider trading.

Most recently, the Sarbanes-Oxley Act of 2002 was passed to prohibit accounting companies and professionals from being involved in insider trading activities. Section 306(a) for instance prohibits employees from trading in their company's stock relating to its pension plan funds during closed periods. The purpose is to avoid insider trading.

It is interesting to note that the South African regulatory framework also prohibits any person (including juristic persons) from practising insider trading and related activities like tipping, in terms of sections 73 and 77 of the New Act. Furthermore, it appears to have adopted the US approach of combating other fraudulent and deceptive practices by providing for a criminal sanction in relation to these practices in terms of sections 75 and 76 of the same Act.

However, the most important feature of the regulatory framework in the US, namely a co-ordinated (joint) effort between the courts and the SEC to co-ordinate the battle against insider trading and related activities seems to be absent in South Africa. It appears that

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[23] A "controlling person" includes not only employers but also any person with the power to influence or control the direction or the management policies or activities of another person. See Gaillard E *op cit* note 22 308.

[24] See Securities Exchange Act Release Number 43154 [2000 Transfer Binder] Fed Sec L Rep CCH 86.319. Also see Palmiter A R *op cit* note 12 371.

there is little co-operation between the courts and the Financial Services Board and therefore a paucity of successful prosecutions or civil claims especially in the courts.[25]

5.2.3. Adequacy of available defences.

A wide range of defences are available to those who allegedly practised insider trading and related activities in terms of the US legislation. For instance, accused persons can escape liability if they prove that they were unaware of the materiality (price-sensitive nature) of the non public information which they possessed. They may also escape liability in terms of section 10(b) and Rule 10b-5 if they prove that they had no fiduciary duty in relation to the affected companies and shareholders or prove that they did not misappropriate or abuse material non public information that relate to the affected securities.[26]

Moreover, they can avoid liability if they prove that they acted under duress or were compelled to deal in the affected securities. However, this defence was unsuccessfully raised by the appellant in the *Harp* case.[27] The court held that Harp had unlawfully misused non public information and failed to prove that he had entered into a contract under a threat or an unlawful or wrongful act or duress, including economic duress.

Another defence at the disposal of an accused or defendant, is to prove that his trading in affected securities was *bona fide* and not aimed at violating any insider trading provisions. This was clearly relied upon in the *Dirks* case[28] where it was held that he did not breach any fiduciary duty to the Equity Funding Corporation of America by

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25 See paragraph 4.6.3 in Chapter 4 of this dissertation.

26 As highlighted *In Matter of Cady, Roberts and Company* *supra* note 21. Also see generally Bullard M E "Insider Trading in Mutual Funds" (2005) 84 *Oregon Law Review* 821.

27 See *Robert D Harp v Corning INC and Corning NetOptix Inc* (2006) US Court of Appeals 2988660 WL (1st Cir Mass).

28 *Dirks v SEC* (1983) 463 US 646-655. See generally Langevoort D C and Gulati G M "The Muddled Duty to Disclose Under Rule 10b-5" (2004) 57 *Vand L Rev* 1639. Also see generally *SEC v Zandford* (2002) 535 US 813-825 and *SEC v Santos* (2003) 292 F Supp 2d 1026.

disclosing massive fraud in its accounting policies. Dirks was a securities analyst who uncovered fraud in the Equity Funding Corporation of America after a tip off from its former employee, Ronald Secrist. He was consequently charged with insider trading. It was alleged that Dirks passed this information to the SEC, and to other persons (clients) who sold their Equity Funding securities to avoid substantial losses before any public disclosure of the fraud was made.[29]

Perhaps the most important defence ever to be developed in the US insider trading legislation is the Chinese Wall.[30] It is specifically provided for in terms of Rule 14e-3 to avoid any prejudice to entities which have developed adequate and effective mechanisms that prevent the abuse of non public confidential information between employees in separate subsidiary divisions of an entity.

Unfortunately, there is no Chinese Wall defence or similar provision in South African law to protect bigger companies and corporations which might have developed adequate measures to avoid any manipulation of non public information between their different departments.[31] The legislature should have adopted adequate defences to avoid prejudice to all innocent persons.

5.2.4. Reliance on both civil and criminal sanctions.

The US regulatory framework relies heavily on both civil and criminal sanctions to discourage insider trading. This can be traced back to the 1934 Act, which provided that any person who violated its provisions was criminally liable for a fine of $10 000 or imprisonment for a period not exceeding 5 years.[32] Furthermore, this Act empowered the

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29 See Bainbridge S M *Corporation Law and Economics* Foundation Press 2002 534-536.

30 A Chinese Wall defence includes polices, a set of procedures which explains the nature of material non public information and the prohibited conduct of employees in relation to that information. See Gaillard E *op cit* note 22 302. Also see Lipton and Mazur "The Chinese Wall Solution to the Conflict Problems of Securities Firms" (1975) 50 *NYUL Rev* 459 464-466.

31 See paragraph 4.5 in Chapter 4 of this dissertation.

32 See section 32(a) of the 1934 Act.

SEC to impose civil liability on such persons of up to 3 times the profit made or the loss avoided as a result of insider trading. However, these sanctions were allegedly inadequate for deterrence purposes and it was generally assumed that many persons benefited from insider trading without any fear of incurring liability. Perhaps, this was also influenced by the fact that insider trading activities were too difficult to detect.

The 1984 Act was enacted as a result of the inadequacy of its predecessor. This Act increased the penalties for insider trading to a fine of $100 000 for natural persons and $500 000 for juristic persons. The maximum imprisonment term for natural persons however remained 5 years. Moreover, the civil remedy remained the same in spite of the wide powers conferred upon the SEC by the Act to claim treble damages from the offenders.[33] Unfortunately, the penalties imposed by this Act were allegedly still inadequate. It remained possible for persons to benefit from their insider trading practices after paying the stipulated fine or after serving their terms in prison.

The 1988 Act was subsequently enacted in a bid to resolve the inadequacy problem and a further amendment to section 32(a) was made. The maximum criminal sentence was increased to a fine of $1 million for natural persons and to $2, 5 million for juristic persons. Furthermore, the imprisonment sentence was significantly increased to a period not exceeding 10 years. It also enabled the SEC to effect a payment of up to 10 percent of the fine collected (*bounty rewards*) to anyone who provided information leading to civil penalties. The purpose is to encourage individuals to expose insider trading activities.[34]

Most recently, these sanctions were further increased by the Sarbanes-Oxley Act of 2002. The maximum fine is now $5 million for natural persons and $25 million for juristic persons and the maximum imprisonment sentence is now 20 years. It is important to note that the criminal sanctions and the civil remedies are enforced by the Department of

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[33] See Botha D *op cit* note 2 10; also see section 32(a) as amended.

[34] See section 21A (e) of the 1988 Act and Palmiter A R *op cit* note 12 370.

Justice and the SEC respectively. This resulted in more successful criminal prosecutions by the courts as well as civil settlements at the instance of the SEC.[35]

The current South African Act also provides for civil as well as criminal sanctions. Furthermore in civil cases it seems as if the provision for a civil penalty of up to 3 times the profit made or the loss avoided was directly borrowed from the US.[36] As is the case in the US, the enforcement of the civil remedy is the responsibility of an independent board, the Financial Services Board (FSB). It is however questionable whether this offered the ideal solution to the South African situation in relation to civil remedies, or whether the legislature should not also have taken note of examples from other jurisdictions such as Australia.

In contrast with the criminal sanction for insider trading in the US, the South African legislature has only provided for a maximum fine of R50 million or imprisonment for a period not exceeding 10 years or both. Moreover no distinction is been made in relation to the sanctions imposed on natural and juristic persons. It appears that these sanctions are still inadequate for deterrence purposes.

5.2.5. The enforcement and effectiveness of insider trading legislation.

The roles of the SEC and of the courts will be discussed under this heading and this will be followed by a comparative analysis of similar enforcement mechanisms in South Africa.

Competent courts play a pivotal role in enforcing the prohibition of insider trading and related practices in the US.[37] Rigorous enforcement and prosecution of such practices is

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35 See for example *SEC v Texas Gulf Sulphur Company* (1968) 401 F2d 833 (2d Cir); *Dirks v SEC supra* note 28; *United States v O'Hagan* (1997) 117 SCt 2199; *United States v Falcone* [2001 Transfer Binder] 91.489 Fed Sec L Rep CCH (2d Cir) and *SEC v Yun* (2003) 327 F3d 1263 (11th Cir).

36 See section 77 of the New Act.

37 These include the US High Courts and Supreme Courts.

clear testimony. The number of reported cases indicates that the courts are effectively enforcing the insider trading prohibition in the US. For instance in the Drexel Burnham Lambert scandal of 1990, Kimba Wood J sentenced Michael Milken to 10 years imprisonment or a criminal fine of $200 million and ordered him to pay a $400 million civil disgorgement of profits fine. Dennis Levine was sentenced to 2 years in prison or a fine of $11, 5 million while Ivan F. Boesky was sentenced to 3 years imprisonment or a fine of $50 million. Milken eventually paid the criminal fine of $200 million and $400 million civil disgorgement profits fine. Dennis Levine also paid the $11, 5 million civil disgorgement of profits fine and Ivan F. Boesky paid the $50 million civil disgorgement fine and an additional $50 million civil penalty.[38]

In *US v O'Hagan*[39] the Supreme Court rejected O'Hagan's plea of not guilty to insider trading charges and held that breach of a fiduciary duty by corporate insiders could also involve breach of a duty of trust and confidence on the part of such insiders or other shareholders of a corporation whose securities are traded.

Furthermore, the recent conviction of the former *Enron* executives, Jeffrey Skilling and Ken Lay for insider trading and related practices is additional evidence of the competence of the US courts. On 26 May 2006 Ken Lay was convicted on six counts of conspiracy and fraud and sentenced to 45 years in prison while Jeffrey Skilling was found guilty on 19 counts of conspiracy, fraud, making false statements and insider trading and sentenced to 185 years in prison.[40] On 23 October 2006, Skilling was criminally convicted on further counts of insider trading and sentenced to an additional imprisonment term of 25 years. The effectiveness of these courts has been made possible by adequate resources

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38 Tomasic R "Insider trading in the USA and United Kingdom" (1991) *Australian Studies in Law, Crime and Justice Series* 31-39.

39 (1997) 521 US 642.

40 See the judgement of the United States District Court S D Texas Houston Division in the case of *In re Enron Corporation Securities Derivative and "ERISA" Litigation Plaintiffs v Enron Corp Oregon Corporation Defendants* (2006) WL 2795321 (S D Tex). Also see Daily M and Whitcomb D "Lay, Skilling face long jail terms as curtain falls on Enron's Empire" http://www.businessday.co.za 26 May 2006.

and governmental support, as well as the fact that competent personnel were allocated to them.

In contrast with the US, it has already been pointed out that very few cases have to date, been successfully dealt with in South Africa.[41]

Although individual persons in the US are entitled to claim damages for insider trading in private litigation, the responsibility for criminal and civil enforcement of the relevant provisions rests primarily on the Department of Justice (the courts) and the SEC respectively.[42]

The SEC was established in terms of section 4 of the 1934 Act as an independent *quasi*-judicial regulatory board. Its main responsibility is to enforce the federal securities laws through the regulation of the stock market and securities industry.[43] For purposes of effectiveness, the SEC is divided into four main divisions namely the Corporate Finance, Market Regulation, Investment Management and Enforcement Divisions.

The Corporate Finance Division oversees compliance with the mandatory disclosure requirement as well as registration by public companies of transactions such as mergers. It also operates online, the Electronic Data Gathering Analysis and Retrieval system (EDGAR system) to ensure equal access to non public inside information for all relevant persons.

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41 A long road must be traversed before the South African courts will attain same effectiveness as the courts in US. See Ciaran R "Another Enron just a heart beat away" (2004) Vol 5 (2) *Deal Makers Magazine* Second Quarter 8-9.

42 See Langevoort D C and Gulati G M *op cit* note 28 1639. Also see Ashe M and Counsell L *Insider Trading: The Tangled Web* Format Publishing London 1990 7-12.

43 The SEC does not work in isolation. Other institutions under its authority include the New York Stock Exchange (NYSE) as well as self regulatory organizations such as the National Association of Securities Dealers (NASD) and the Municipal Securities Rule Making Board (MSRB). Also see Spandaccini M "When Greed is not Good: The Law of Insider Trading" *Securities Law Report* (April 2003) Vol 6 http://www.amazon.com 14 August 2006 and Palmiter A R *op cit* note 12 402-415.

The Market Regulation Division regulates the New York Stock Exchange, the National Association of Securities Dealers, the Municipal Securities Rule Making Board and other Self Regulatory Organizations. It interprets any proposed changes to regulations, publicizes investment related topics for public education and monitors operations of the industry.

The Investment Management Division oversees investment companies and their advisory professionals. It also administers federal security laws to improve the disclosure of non public inside information and to minimize prejudice to investors without imposing an undue burden on regulated companies.

While the Enforcement Division investigates any violation of the laws and rules that govern insider trading and other related practices, its extensive investigatory powers include issuing subpoenae for production of relevant evidence such as documents and compelling suspects and others to testify in the courts. Furthermore, it has powers to enforce the civil remedies, institute administrative orders, recover any illegally obtained profits from guilty persons (disgorgement of profits), impose punitive penalties on such persons and refer criminal matters to the Department of Justice.[44]
Another important element of the US regulatory framework is the Department of Justice. Thus the Supreme Courts and the High Courts in the US are responsible for hearing criminal cases against persons accused of insider trading or related illicit practices.

This co-operative effort of the SEC, private litigants and the Department of Justice in the enforcement of statutory, judicial and regulatory rules against insider trading and related practices has to an extent been effective. The provision of adequate resources, competent personnel in the courts and the availability of adequate technological surveillance

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[44] See generally Dooley M "Enforcement of Insider Trading Restrictions" (1980) 66 *Virginia Law Review* 1-83; Carlton D W and Fischel D R "The Regulation of Insider Trading" (1983) 35 *Stanford Law Review* 857-895. Also see *The Northwest Herald* (Unknown author) "Qwest ex-chief charged with insider trading" http://www.nwherald.com 12 August 2006 and Bainbridge S M *op cit* note 29 571-573.

mechanisms to detect insider trading and related activities also contributed significantly to the success achieved in the US. It enhanced enforcement in practice of the insider trading legislation which was reflected in a significant number of cases that were successfully adjudicated to date.[45]

In contrast to this, a similar regulatory framework in South Africa is still inadequate and less effective. Although the South African legislation on insider trading and related activities was highly influenced by the corresponding US legislation, it seems to lack a rigorous practical enforcement approach and infrastructure to combat insider trading. This is evidenced by many delays in prosecutions and the paucity of successful cases that were reported in South Africa to date.[46]

5.3. CONCLUDING REMARKS.

The prohibition on insider trading and related offences in the US is generally accepted by the public, the judiciary and all the market participants in that country.[47] In other words, the prevalent attitudes in the US favour a rigorous enforcement and prosecution of such offences.[48]

Although the adoption of some principles from the US regulatory framework shows a significant effort by the legislature to provide an adequate insider trading proscription in

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45 See cases *supra* notes 27, 35 and 40. Also see *SEC v One or more purchasers of call options for the Common Stock of CNS INC* (2006) US District Court 3004875 WL (E D Pa) and Dolgopolov S "Insider Trading and The Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making" (2004) 33.83 *Capital University Law Review* 84.

46 See analysis in paragraph 4.3.7 of Chapter 4 of this dissertation.

47 See Steinberg M I *op cit* note 1 29.

48 See generally *SEC v Sargent* (2000) 229 F 3d 68-75 (1st Cir) which displays the determination of the judiciary in enforcing insider trading provisions by upholding convictions based on circumstantial evidence. Also see section 32(a) of the Securities Exchange Act; Bergmans B *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the US and the European Community* Graham and Trotman London 1991 41-60.

South Africa, deficiencies such as inconsistent provisions and apparently ineffective enforcement mechanisms have directly impeded these efforts.

It is submitted that the legislature should not have blindly adopted the US regulatory principles without adequate measures in place to enforce them. Perhaps, more emphasis should have been placed on procuring adequate technological surveillance machinery, training of competent personnel and educational awareness programmes to combat insider trading and not to duplicate the flaws in the US regulatory framework.

CHAPTER SIX

THE REGULATION OF INSIDER TRADING IN CANADA: A COMPARATIVE PERSPECTIVE.

6.1. INTRODUCTION.

A well developed regulatory framework is also in place in Canada. The Canadian system was regarded by one commentator as one of the most effective and adequate systems to be found in recent years.[1] It is actually characterized for its stringent but effective statutory prohibitions on insider trading.[2]

It is against this background that an incisive comparative analysis will be carried out in this Chapter, of the Canadian and the South African statutes to explore their similarities and differences. Any meaningful lessons that can be learnt and innovations that can be recommended for adoption in South Africa will be identified. Relevant Canadian cases and provisions will be analysed and contrasted with their South African counterparts. The discussion of the Canadian insider trading prohibition is predominantly focused on the Ontario Securities Act of 1990 as amended.[3]

6.2. OVERVIEW OF INSIDER TRADING LEGISLATION IN CANADA.

The statutory regulation of insider trading is still predominantly a provincial matter in Canada despite several attempts to enact a single uniform federal statute.[4] The first

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1 See Osode P C "Regulatory theory, Private Interests and the Rationality of Insider Trading Regulation in the United States and Canada" (1998) 3 *Journal of South African Law* 427 437.

2 See Osode P C "The Regulation of Insider Trading in Canada: A Critical Appraisal" (1999) 28 *Anglo-American Law Review* 166.

3 A critical examination of all the provincial insider trading legislation in Canada and cases is not possible due to constraints in relation to space.

4 See Welling B *Corporate Law in Canada: The Governing Principles* 2nd ed Butterworths Canada Ltd 1991 363.

statute on insider trading in Canada was the Ontario Securities Act of 1966 (OSA),[5] which was passed pursuant to the adoption of the *Report of the Attorney General's Committee on Securities Legislation in Ontario* on 11 March 1965.[6] Prior to this date, insider trading was not statutorily regulated in Canada. This Act was however only applicable to insider trading activity in the securities of "reporting issuers".[7] This led to various subsequent legislative reviews of the OSA and similar statutes in the other provinces in an attempt to have more stringent and adequate provisions against insider trading.

The insider trading prohibition was for instance also contained in the Canada Corporations Act of 1970 (CCA). This Act was aimed at preserving the integrity of federal companies by protecting their shareholders against insider trading.[8] Moreover the CCA prohibited insiders or other persons who held positions of trust or otherwise from trading in securities of a company if they were privy to price-sensitive information relating to such securities which was not yet available to all its shareholders.

A subsequent review of the CCA resulted in the enactment of the Canada Business Corporations Act of 1975 (CBCA).[9] This Act prohibited insider trading in a "distributing corporation", which was defined as a corporation whose shares have been part of a distribution to the public, if their price remains outstanding and they are held by more than one person. Furthermore, the CBCA prohibited insiders from selling shares that they do not own or have a right to own, and from buying or selling a call option or put

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5 *Statutes of Ontario* 1966 c 142. See sections 108-117 which contained the first insider trading prohibition in Canada.

6 This report is hereinafter referred to as the *Kimber Report*. See in particular paragraphs 1.06, 1.11 and 7.15 of the *Kimber Report*.

7 A reporting issuer is a corporation or a company whose securities are traded on a stock exchange or other market place.

8 *Multiple Access Ltd v McCutcheon and others* (1982) 138 DLR (3d) 18 (SCC).

9 Canada c 33. Also see generally Welling B *op cit* note 4 365 and Smith M "Insider Trading" http://www.parl.gc.ca 22 December 1999.

option in respect of a share of the distributing corporation in relation to which they are insiders.[10]

In an attempt to complement and revive the original insider trading provisions which were contemplated in the OSA, the Ontario Business Corporations Act of 1982 (OBCA.) was enacted.[11] Furthermore, it broadened the definition of insiders to include not only "senior officers", but all the employees of any corporation or company. However, it dealt mainly with the liability of insiders of corporations or companies that do not offer securities to the public.[12]

This eventually led to yet another legislative review of the OBCA which resulted in the enactment of the Ontario Securities Act of 1990 as amended.[13] This Act expanded the reporting obligations of all insiders[14] of the reporting issuers in terms of section 107. This was meant to deter insiders from profiting unfairly from their prior knowledge of any unpublished confidential inside information relating to a company, such as an impending take-over or other acquisition.

Recently, in 2003 the Canadian Securities Administrators (CSA) and the federal government introduced a Uniform Securities Law Project (USL) and a Bill C-46 respectively in an attempt to improve the overall regulation of insider trading in all the provinces of Canada.[15] Firstly, the USL Project seeks to provide a national framework

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10 See sections 126(1) and 130 of the CBCA.

11 S O 1982 c 4. Also see generally *Ontario Securities Legislation* CCH Canadian Limited 1977 46-47.

12 See Welling B *op cit* note 4 364.

13 *Revised Statutes of Ontario* 1990 c S 5. This statute is hereinafter referred to as the 1990 OSA. Also see Macintosh J G and Christopher N C *Essentials of Canadian Law: Securities Law* Irwin Law Inc 2002 231.

14 See section 1(1) of the 1990 OSA.

15 For a detailed analysis see the Insider Trading Task Force Report (ITTF) on "Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence" (November 2003) http://www.regulationservices.com/en/pdf/1TTFReport_20031112.pdf 35 26 May 2006.

for securities regulation by the harmonization of insider reporting obligations. Secondly, Bill C-46 proposes to establish new *Criminal Code* offences for illegal insider trading and for tipping.

Most recently, Bill C-13 was introduced in March 2004. This Bill will create the first specific *Criminal Code* offences in relation to insider trading and other related practices. It also proposes to make it an offence to threaten or retaliate against employees who reveal any insider trading or related activities (whistle blowing).

Unlike in Canada, the statutory regulation of insider trading in South Africa is centralized and specifically prohibited in terms of the Securities Services Act, 36 of 2004. The provincial regulation of insider trading approach which contributed immensely towards curbing insider trading and related practices in Canada will probably not be followed in South Africa. This may perhaps, contribute towards the lack of awareness and of effective combating of the insider trading activity in South Africa.[16]

6.2.1. The scope and meaning of "insider trading".

It seems as if Canada has also followed the American approach by electing not to define the controversial concept of insider trading.[17] Only a few terms such as "insider", "reporting issuer", "special relationship", and "issuer" are comprehensively defined. Other fairly important terms like "tippees", "inside information" and "illegal insider trading" are not defined. Insider trading is therefore generally regarded as a practice that involves the buying or selling of securities under circumstances where one of the parties is in possession of undisclosed material information about the securities or about the issuer, or where that information has been tipped off to one of the parties or where securities are being traded by the person who was tipped.[18]

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16 See Chapters 2, 3 and 4.

17 See paragraph 5.2.1 in Chapter 5 of this dissertation.

18 See the ITTF Report *op cit* note 15 1. Also see Macintosh J G and Christopher N C *op cit* note 13 237.

It is interesting to note that South Africa seems to be following this American approach as well. More specifically, no definition of insider trading is proscribed in the current regulatory framework.[19] However it remains to be seen whether the South African regulatory framework will be as effective as its Canadian counterpart.

6.2.2. The prohibition on "insider trading".

The provisions of the 1990 OSA prohibits any person in a *special relationship*[20] with a reporting issuer and who has knowledge of an undisclosed *material fact* or *change*[21] of relevant circumstances relating to securities to disclose it to others or to trade on the basis of such information to the detriment of others.

It is plausible to note that the insider trading prohibition in terms of section 76 applies to a much wider range of persons and companies than is covered by the definition of "insider" in section 1 of the 1990 OSA.[22] Thus, the most important definition in section 76 is not that of an "insider" but rather that of a "special relationship person". The term "special relationship" was specifically defined in terms of section 76(5) to mean:

(a) insiders, affiliates[23] and associates[24] of a reporting issuer and others engaging in *various transactions*[25] with respect to such issuers;[26]

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19 See Chapter 4 of this dissertation.

20 See section 76(5) of the 1990 OSA.

21 The terms were defined to constitute a change in business, operations or capital of an issuer or a fact that can reasonably be expected to have a significant effect on the market price or value of the securities of the issuer. See section 1(1) of the 1990 OSA.

22 Macintosh J G and Christopher N C *op cit* note 13 238.

23 This term is defined in section 1 paragraph 1.1(2) of the 1990 OSA.

24 This term is defined in section 1(1) of the 1990 OSA

25 Such transactions include firstly, the making of a takeover bid or secondly, entry into a business combination such as a reorganization, or a merger or thirdly, acquisition of a substantial portion of the issuer's property.

26 See section 76(5)(a)(i), (ii) and (iii).

(b) persons or companies engaged in or proposing to engage in any business or professional activity with or on behalf of a person that is proposing to engage in similar transactions with the reporting issuer;[27]

(c) directors, officers or employees of the reporting issuer and others proposing to engage in similar transactions as contemplated in sections 76(5)(a)(ii) or (iii) and 76(5)(b);[28]

(d) a person or company that learned of the material fact or change with respect to the reporting issuer, while the person or company was a person or company described in subsections (a),(b) or (c) above;[29]

(e) a person or company that learns of a material fact or change with respect to the reporting issuer from any other person or company described in this section who knows or ought reasonably to have known that the other person or company is in such a relationship.[30]

It is clear that this definition covers not only those persons who work within the reporting issuer, but also others who work within different companies proposing to enter into a major business transaction or arrangement such as a takeover of the issuer's shares. Moreover, other related practices such as tipping are covered as well. For instance, unlawful disclosure to another of unpublished material information relating to the reporting issuer's securities, whether by that issuer, a special relationship person or any other person in possession of such information, is prohibited in terms of section 76(2) and (3). In order to reduce the risk of illicit insider trading, all persons referred to in section 76 of the 1990 OSA are prohibited from speculating in the securities of any corporation or company.

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27 Section 76(5)(b).

28 Section 76(5)(c).

29 Section 76(5)(d).

30 Section 76(5)(e).

6.2.3. Reliance on both civil and criminal sanctions.

Civil as well as criminal sanctions are used to curb both insider trading and tipping in Canada. The criminal sanction will be discussed first, then the civil remedy and lastly, a comparative analysis will be made with respect to similar sanctions in South Africa.

Any special relationship person who violates the provisions of section 76, whether through tipping or engaging in unlawful insider trading will be liable for a criminal offence.[31] If convicted, such persons may be sentenced to pay a fine equal to the amount of the profit made or loss avoided but up to a maximum of $1 million, or to imprisonment for two years or both.[32] Such persons may further be ordered to pay an additional penal fine up to an amount that is three times the amount of the profit made or loss avoided.[33] Furthermore, with respect to tipping, it is not required that the tippees should have traded on the premise of the confidential inside information they received from special relationship persons, before any criminal liability can be imputed on them. Recently, Bill C-13 of 2004 proposed to introduce the first specific *Criminal Code* sanctions for insider trading and tipping of a maximum imprisonment term of up to ten years and five years respectively.

A civil remedy is available to all the persons who fall victims of unlawful insider trading and tipping in contravention of the provisions of section 76.[34] For instance, any special relationship person who trades while in possession of unpublished price-sensitive information is liable to compensate all the affected persons (plaintiffs) for any damages caused by such trading.[35] It is plausible to note that this civil remedy is available to four classes of plaintiffs:

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31 See sections 122(1)(c) and 76(1), (2) and (3).

32 See section 122(1).

33 See section 122(4) and *R v Harper* (2000) O J 3664 where the accused was convicted on two counts of insider trading in terms of section 122(1)(c).

34 See section 134(1).

35 See *Doman v British Columbia (Superintendent of Brokers)* (1998) BCJ 2378 (CA).

- firstly, those who are the innocent counterparties to unlawful insider trading with insiders;
- secondly, those who are the innocent counterparties to insider trading with tippees;
- thirdly, to mutual funds or the clients of portfolio managers or of registered dealers, against someone who *had access to* unpublished confidential information relating to the investment program of those funds, managers or dealers and who benefits *by trading* on the basis of such information;[36]
- and lastly, reporting issuers whose insiders, affiliates, or associates have gained by trading with knowledge of undisclosed material information or have communicated such information to others.[37]

The basis for liability in terms of section 134 differs, depending upon whether the plaintiff is an innocent party to the unlawful trade or is the reporting issuer to which the undisclosed information relates. Innocent counterparties to unlawful insider trading are entitled to recover from the defendant any damages they may have suffered as a result of such trading. On the other hand, in cases of actions brought by a reporting issuer, liability of insiders, associates or affiliates of such an issuer is measured by the extent of any gain they have realized as a result of insider trading.

It is interesting to note that in South Africa, provision is also made for criminal sanctions as well as civil remedies to curb insider trading and related practices.[38] However, unlike the position in Canada, the defendant's civil liability in terms of the current South African legislation is not contingent upon whether the affected person is an innocent counterparty or not. It is however submitted that such a distinction should be drawn and that South Africa would be well advised to follow the Canadian law in this respect.

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36 See section 134(3).

37 Section 134(4). Also see generally Williamson J P *Securities Regulation in Canada* University of Toronto Press 1960 347-352.

38 See paragraphs 4.3.4 and 4.4 in Chapter 4 of this dissertation.

6.2.4. The role and effectiveness of the Intermarket Surveillance Group (ISG).

The ISG was established to provide an intermarket insider trading framework for the sharing of information and the coordination of regulatory efforts among securities and commodities markets and market regulators in North America, Europe and Asia.[39] This framework is responsible for combating intermarket trading abuses and developing best practices.

It is important to note that Canada is a member of the ISG, and its equities and derivatives markets can therefore trade with similar markets around the world. Moreover, it is agreed that the technological surveillance department of the ISG enables Canadian markets to effectively detect any patterns of illegal insider trading in Canadian equities and derivatives on markets globally. The ISG further implemented a database that assists member market regulators to share relevant information and to investigate intermarket insider trading. However it is not clear whether Canada had successfully utilized this database to curb insider trading.

Contrary to this international initiative to combat insider trading and the participation of Canada therein, no similar development seems to have taken place in South Africa. South Africa should seek to become involved in international initiatives such as the ISG and co-operate and where possible to exchange information with other jurisdictions so that insider trading can be regulated more effectively.[40]

6.2.5. The role and effectiveness of Insider Trading Task Force (ITTF).

The ITTF was established in September 2002 by Canada's securities regulatory authorities with the objective of evaluating how best to curb illegal insider trading in Canadian capital markets. This followed concerns by some securities regulators that there was a public perception that unlawful insider trading was prevalent and increasing

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[39] See the ITTF report *supra* note 15 33.

[40] Also see generally Manne H G *Insider Trading and the Stock Market* The Free Press 1966 160-169.

in Canadian markets, at a time when few successful enforcement actions against such trading in the courts, were recorded. The regulatory authorities that expressed concerns were the Ontario, British Columbia and Alberta Commissions, *Commission des valeurs mobilieres du Quebec*, Investment Dealers Association of Canada, *Bourse de Montreal Inc* and the Market Regulation Services Inc.

Therefore, the role of the ITTF is to examine unlawful insider trading in Canadian securities markets in order to determine more effective means of curbing it. It is empowered to devise suitable methods of increasing the capacity of regulators to detect insider trading when it occurs in offshore and nominee accounts, by coordinating the regulation of equities and their derivatives. For instance, 15 of about 289 insider trading cases investigated in Canada between 2001 and 2002 involved offshore accounts.[41] The ITTF is also empowered to promulgate best *practices* or *principles* for dealers, issuers and service providers to limit the leakage of inside information. Furthermore, the ITTF is responsible for increasing any deterrence efforts by ensuring that the provisions of insider trading statutes are adequate, and that there is better coordination among regulatory authorities as well as improved enforcement mechanisms.

For purposes of adequacy and effectiveness, the ITTF focuses on three main policy goals which are:

(i) deterrence;
(ii) detection; and
(iii) prevention.

It is submitted that the ITTF has contributed immensely towards the effectiveness of the Canadian insider trading regulatory framework.[42]

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41 For a comprehensive and analytical discussion see "Insider trading – What's the problem?" http://www.cbc.ca/news/background/crime/insider_trading.htm 21 December 2006.

42 See the ITTF report *supra* note 15 1.

Unlike the position in Canada, it seems as if the legislature in South Africa ignored the role and importance of establishing a similar task force to combat insider trading. It is unfortunate that the legislature rigidly imposed the so-called wide investigatory and enforcement powers on the Financial Services Board (FSB) only.[43] Other regulatory bodies such as the Bond Exchange of South Africa (BESA) should perhaps have been incorporated to compliment the efforts of the FSB in enforcing the insider trading prohibition.

6.2.6. Establishment of competent courts to prosecute insider trading cases.

In Canada, both the High and Supreme Courts are empowered to prosecute insider trading cases. It should be noted that this important role of the courts is acknowledged in the various provincial securities statutes as well as other securities statutes such as the Canada Business Corporations Act of 1985.[44]

However, in terms of the various provincial statutes, the compliance orders that the courts may impose, differ from one province to the other. For instance, the disgorgement orders, civil penalties, monetary fines and imprisonment terms imposed by the courts in Alberta may be different from those imposed by the courts in Ontario. Moreover, in *quasi*-criminal proceedings, competent courts in various provinces may impose fines ranging from $1 million to $5 million, or for payment of a multiple of the profits made and imprisonment sentences for periods that range between three and five years.[45]

Although it appears that the sanctions that may be imposed by courts are not uniform, it is submitted that these courts still play a substantial role in the curbing of illegal insider trading and related practices in Canada.[46] Moreover, the number of reported successful insider trading cases that were recorded to date in both criminal and civil proceedings is,

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43 See paragraph 4.6.1 in Chapter 4 of this dissertation.

44 C C-44 RSC 1985.

45 See ITTF report *op cit* note 15 41.

46 *Ibid.*

unlike the situation in South Africa, clear testimony of the effectiveness of the courts.[47] In spite of some of the FSB investigations which have been instituted through the Directorate for Market Abuse (DMA) in South Africa, many cases are still pending in the courts. This directly points to the fact that the role of the courts in curbing insider trading in South Africa has not been as effective as it is in other developed countries such as Canada.

With respect to civil cases, clear guidelines are provided in terms of the 1990 OSA by which the courts may determine the compensatory damages for prejudiced persons.[48] It is submitted further that the courts have a discretion where necessary, to supplement the guidelines in section 134(6) with additional, adequate and appropriate measures as the circumstances of each case may dictate. This has enabled the courts to successfully sanction many settlements in civil cases.

6.2.7. The adequacy of available defences and exemptions.

A number of defences as well as exemptions are available for insiders or any other person alleged to have contravened insider trading provisions in Canada. For instance in terms of the 1990 OSA, any person accused of contravening section 76 may avoid liability if he is able to rely on the proscribed defences or exemptions. These are the following:

- With respect to tipping, any person who as a *tippee* knowingly trades on the basis of material confidential information before it is "generally disclosed"[49] may escape liability if he proves that he did not know or ought not reasonably to

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[47] See *Green v Charterhouse Group Can. Ltd* (1976) 12 OR (2d) 280 (CA); *Lewis v Fingold* (1999) 22 OSCB 2811; *In the Matter of MCJC Holdings Inc and Michael Cowpland* (2002) 25 OSCB 1133. See also the cases quoted in notes 8, 33, and 35.

[48] See section 134(6).

[49] This term is not defined in terms of the 1990 OSA but it is clear that mere issuing of a press release without actual and timeous disclosure of material facts to the public is insufficient. Also see *Green v Charterhouse Group Can Ltd supra* note 47 302-303.

have known, that the tipper was a person or a company in a special relationship with the reporting issuer.[50]

- Another defence in terms of section 76(4) is only available to a person who traded on the basis of the undisclosed confidential information which he reasonably believed that it had already been publicly disclosed.

- Moreover, in terms of section 76(4) any accused person may avoid liability for insider trading if he proves that he has traded on the premise of undisclosed price-sensitive information which was known or ought reasonably to have been known to the plaintiff as the affected person.
- The courts have also recognized a "reasonable mistake of fact" defence in some instances where the accused person mistakenly traded on price-sensitive before it had been generally disclosed.[51]

- Furthermore, for purposes of the containment of inside information, the Chinese Wall defence is available to corporations or companies that implemented this defence to prevent abuse of inside information between their different departments.[52]

- In addition to these defences, liability for violating sections 76 and 134 of the 1990 OSA can still be avoided in terms of the exemptions provided for in terms of section 175 of the Ontario Securities Act Regulation, for instance, where accused persons who participated in, or who advised on a particular trading

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[50] See section 76(4). Also see *Re Harold P Connor* (1976) OSC Bulletin 149 174 for a discussion of the circumstances suggested by the Ontario Securities Commission to determine whether the confidential information is generally disclosed.

[51] See *Lewis v Fingold supra* note 47 where the accused was acquitted after he successfully raised the defence of mistake. Also see generally Rider B A K *Insider Trading* Jordan and Sons Limited 1983 283-301.

[52] See OSC Policy 33-601. Also see *Transpacific Sales Ltd (Trustee for) v Sprott Securities Ltd* (2001) OJ 597 (Sup Ct).

decision did not have actual knowledge of the undisclosed price-sensitive information or where the purchase or sale of the securities occurred pursuant to a pre-existing agreement, plan or commitment. These exemptions are also available to a person who or a company which, was acting as an agent for a third party pursuant to a specific order.

- In contrast to these developments in Canada, the defences in the South African legislation do not cover these situations. Perhaps, the South African legislature should adopt similar exemptions to ensure that accused persons who have acted in good faith are not restricted to a few and inadequate defences.[53] It is crucial that the South African legislature enact adequate defences or exemptions for insider trading and related practices to avoid prejudice to persons who are incorrectly prosecuted.

6.2.8. The enforcement and effectiveness of insider trading legislation.

Various enforcement organs such as the Ontario Securities Commission (OSC), Integrated Market Enforcement Teams (IMETS), Self Regulatory Organisations (SRO), Intelligent Market Monitoring System (IMM), Canadian Investor Relations Institute (CIRI), Canadian Securities Administrators (CSA) and the Canadian Institute of Chartered Accountants (CICA) have each played a significant role in the effective implementation and enforcement of the insider trading legislation in Canada. The enforcement of insider trading laws in Canada is clearly a shared responsibility involving the federal government, provincial governments and many other securities regulators.

The OSC was established in 1966 as an administrative agency empowered to oversee securities trading and to provide public scrutiny of the investment market place, in order

[53] See paragraph 4.5 in Chapter 4 of this dissertation.

to combat illicit practices such as insider trading.[54] It has several powers which include amongst other things, powers to cease trade orders, issue compliance orders, and impose punitive and administrative penalties in civil cases.[55] For instance, it may impose administrative penalties ranging from $100,000 to $1 million on individuals and $500,000 to $1 million on corporations or companies (juristic persons).

The OSC Policy 33-601 was introduced in 1998, to give guidelines relating to employee education, containment of inside information, compliance and restriction of transactions. Firstly, employee education involves education about insider trading and the prohibition thereof, ethical standards and consequences for violating the insider trading provisions. Secondly, containment (protection) of inside information involves limiting unauthorized transmission thereof by restricting access to inside information, keeping information in sensitive areas secure and ensuring that electronic transmission of such information takes place under adequate supervision and control. Thirdly, restriction of transactions involves the use of grey lists, restricted lists and information barriers. Lastly, compliance includes the monitoring and reviewing of trading in the OSC registrants' accounts, monitoring and restricting trade in securities about which the registrant or its employees may possess inside information, requiring all employees to maintain accounts with the employer registrant only, and conducting a periodic review of the adequacy of policies and procedures.[56]

The OSC also requires reporting issuers to report insiders in relation to them within ten days.[57] In May 1999, the OSC released *A Guide to Insider Reporting*[58] in an attempt to

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54 See Welling B *op cit* note 4 363. Also see Mann M D and Lustgarten L A "Internationalization of Insider Trading Enforcement - A Guide to Regulation and Co-operation" in Hopt K J and Wymeersch E (eds) *European Insider Dealing – Law and Practice* Butterworths 1991 368.

55 See Ziegel J S (ed) *Studies in Canadian Company Law Volume 2: Corporation and Securities Law in the Seventies* Butterworths 1973 444-449. Also see *International Claim Brokers v Kinsey* (1966) 57 DLR (2d) 357; 55 WWR 672 (BCCA).

56 See ITTF report *supra* note 15 15-16. Also see "A Guide to What Constitutes Inside Information" http://www.uilo.ubc.ca 22 April 2006.

57 See section 107(1) and OSC Rule 55-501(1996) 19 OSCB 821.

ensure compliance with the insider trading prohibition. Moreover, a System for Electronic Disclosure by Insiders (SEDI) was adopted in 2001 to simplify the reporting and filing process of all insiders of the reporting issuer.[59] It is further submitted that section 135 of the 1990 OSA provides a method by which the OSC, security holders of a reporting issuer or security holders of a mutual fund may, in terms of section 134(3) or (4), institute an action in the name of the issuer or the mutual fund against those who traded unlawfully.

Apart from the OSC, the federal government as part of its efforts to strengthen enforcement of the provisions against illegal insider trading and related practices, created the IMETS in Toronto, Montreal, Vancouver and Calgary to investigate capital markets fraud and insider trading cases. An effective process within the IMETS structure to address unlawful insider trading incorporates the activities of securities commissions such as the OSC, SRO, Department of Justice and police officers who are highly qualified financial investigators.[60]

The IMETS and the proposed *Criminal Code* offences in relation to insider trading and tipping, represent additional enforcement machinery included in the federal government's coordinated and integrated regulatory approach towards curbing insider trading in Canada. With respect to enforcement of criminal sanctions, it is expected that the IMETS are going to develop and enhance case assessment criteria, integrated procedures for speedy addressing and fast tracking of insider trading cases.[61]

Another important enforcement organ is the SRO. For purposes of this dissertation, member organizations of the SRO include the Market Regulation Services Inc, *Bourse de*

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58 See http://www.osc.gov.on.ca 22 April 2006 and also see generally Bewsey J and others *The Law of Investor Protection* 2nd ed Sweet and Maxwell Limited 2003 287-295.

59 See National Instrument 55-102 (2001) 24 OSCB 4414 and http://www.sedi.ca 15 January 2007.

60 For a comprehensive discussion see "Federal Strategy to Deter Serious Capital Market Fraud" (June 2003) http://www.justice.ca/en/new/nr/2003doc30928.html 18 November 2006.

61 See ITTF report *op cit* note 15 44 and also see generally Ashe M *Insider Dealing* The Round Hall Press 1992 38-44.

Montreal Inc (an exchange that specializes in options), CIRI, CICA and IMM. These organizations have to date successfully worked with other Canadian securities regulatory authorities in combating insider trading and related practices.[62]

It should be noted that the courts have also contributed immensely towards curbing insider trading in Canada. This is evidenced by numerous reported cases such as the *Russell J Bennett, William R Bennett and Harbanse S Doman* case which involved approximately $2, 3 million in losses avoided, pursuant to a sale of Doman Industries Limited shares in 1988, the *Glen Harper* case which involved approximately $3, 6 million in losses avoided from selling shares of Golden Rule Resources Limited in 1997 and the *MCJC Holdings Inc* case involving the sale of $20, 4 million in Corel Corporation shares also in 1997. These cases suggest that there is at least some degree of enforcement of the insider trading legislation by the Canadian courts,[63] which is in contrast with the South African scenario as has previously been pointed out.

6.3. CONCLUDING REMARKS.

Although it appears that the Canadian insider trading regulatory framework is not always uniform,[64] it is generally agreed that the Canadian system is comparable to international best practice. Therefore, despite the fact that the insider trading legislation varies from province to province and that enforcement is not the responsibility of a single regulatory organ, many insider trading cases have to date been successfully prosecuted in Canadian courts.

It is against this background that this researcher submits that in order to have adequate insider trading legislation, the South African legislature should draw some meaningful lessons from similar legislation in Canada. The South African legislature would be well

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62 See ITTF report *op cit* note 15 23-29.

63 See paragraph 6.2.6 of this Chapter.

64 There is different legislation in force both federally and provincially. These laws are constantly amended or being reviewed.

advised to adopt the Canadian approach of involving more specialized bodies and securities regulatory authorities by statute to enforce the insider trading prohibition.

CHAPTER SEVEN

THE REGULATION OF INSIDER TRADING IN AUSTRALIA: A COMPARATIVE PERSPECTIVE.

7.1. INTRODUCTION.

It is widely acknowledged that Australia currently has the most developed insider trading legislation in the world.[1] Its regulatory framework prohibits insider trading indirectly through common law and directly through statutory insider trading provisions.[2] Moreover, in Australia, the insider trading prohibition is well received by both the investing and the non investing public. This co-operative and co-ordinated approach resulted in an increased awareness and effective curbing of insider trading and other related activities in the Australian securities markets, corporations and companies.

The successful track record of the Australian regulatory framework therefore demands an in–depth comparative analysis. In this Chapter the significant lessons which may be learnt from developments in Australia will be considered for the purpose of recommending amendments to the South African regulatory framework. However, the comparative analysis will mainly concentrate on the provisions of the Corporations Act.[3]

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1 See Huang H "The Regulation of Insider Trading in China: A Critical Review and Proposals for Reform" (2005) 17 *Australian Journal of Corporate Law* 281-322, who argues that China and other countries that follow the American (US) insider trading principles should consider adopting the Australian model or principles to enhance their efforts of combating of insider trading practically and effectively.

2 See Ziegelaar M "Insider Trading Law in Australia" in Walker G and Fisse B (eds) *Securities Regulation in Australia and New Zealand* Oxford University Press 1994 677-678.

3 See the Corporations Act of 2001 (C'th). This statute is hereinafter referred to as "the 2001 Act".

7.2. OVERVIEW OF INSIDER TRADING LEGISLATION IN AUSTRALIA.

The prohibition and regulation of insider trading was introduced in Australia in the early 1970's, when statutes such as the Securities Industry Act of 1970 (NSW) were enacted to give Australia its pioneering insider trading provisions. This Act imposed criminal and civil liability on any person who traded with another person associated to or in association with a corporation or company for purposes of obtaining a financial advantage, gain or profit, if that person possessed specific price-sensitive inside information relating to the corporation or company which was not generally available (known) to the public.[4]

The Securities Industry Act of 1975 (NSW) was thereafter introduced in an attempt to strengthen the insider trading prohibition. This Act as amended broadened the insider trading prohibition to incorporate similar prohibitions which were also contained in the provincial statutes of Queensland, Victoria and Western Australia.[5]

Subsequent review of the insider trading legislation led to the enactment of the Securities Industry Act of 1980 (NSW). Its provisions added a few changes to the insider trading prohibition contained in its predecessor. For example, it included more elaborate civil remedies for all persons who were prejudiced by insider trading and related activities such as tipping.[6]

Furthermore, the Corporations Act of 1989[7] was enacted at a federal level. This Act prohibited insider trading *indirectly* through common law by punishing any officer, adviser or employee of any corporation or company who negligently or fraudulently

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4 See section 75A.

5 See section 112; Baxt R, Black A and Hanrahan P *Securities and Financial Services Law* 6th ed Lexis Nexis Butterworths 2003 503-504.

6 See section 128. Also see Baxt R, Black A and Hanrahan P *op cit* note 5 503-504.

7 Corporations Law of 1989 (C'th). This Act is hereinafter referred to as "the Corporations Law".

breached their fiduciary duties by practising insider trading.[8] The general common law fiduciary principles requiring these persons to act in good faith and with reasonable care were therefore applicable. The statutory (direct) prohibition on insider trading was contained in Division 2A of Part 7.11 of the same Act. It prohibited any person who had non public price-sensitive inside information relating to securities to subscribe for, purchase or sell such securities. It also prohibited any such person from directly or indirectly communicating (tipping) such information to another person, the tippee.[9]

In 1990, yet another legislative review was undertaken and the *Corporations Law* of 1990 (as amended) came into force. However, shortly and before contributing much towards curbing of insider trading in Australia, its provisions were amended and repealed by the Corporations Legislation Amendment Act of 1991. This followed the adoption of several recommendations made in a Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs (Griffiths Committee) in October 1989.[10]

Currently, the insider trading prohibition is proscribed in the 2001 Act. Its provisions are aimed at ensuring free and fair operation of securities markets to avoid harm to any person caused by insider trading and similar activities. Thus, the Australian legislature seeks to encourage a free and informed market which promotes and enhances public investor confidence.[11] Unlike its predecessors, the 2001 Act does not rely on fiduciary and misappropriation theories. Its main focus is on the possession and use by insiders or any other person of non public price-sensitive inside information that relates to a company or to any listed securities, the so-called *information connection only approach.*

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8 See section 232(5); Ziegelaar M *op cit* note 2 678 and also see Tomasic R and Bottomley S *Corporations Law in Australia* The Federation Press 1995 690-698.

9 See section 1002G. Also see generally Cox J D "An Outsider's Perspective of Insider Trading Regulation in Australia" (1990) 12 *Sydney Law Review* 455 463-470.

10 See section 1002; Baxt R, Black A and Hanrahan P *op cit* note 5 503-504. Also see generally Anisman P "Insider Trading Legislation for Australia: An Outline of Issues and Alternatives Report" 1986 63-65.

11 See Division 3 of Part 7.10 of the 2001 Act. See further Lyon G and Du Plessis J J *The Law of Insider Trading in Australia* The Federation Press 2005 12-13.

On the other hand, it seems as if the South African regulatory framework still has to travel some distance before it would attain the same adequacy, competitiveness and efficacy as its Australian counterpart.[12] Therefore, it is against this background that this researcher submits that the South African legislature should emulate and where possible adopt some of the regulatory provisions of Australia.

7.2.1. The scope and meaning of "insider trading".

The concept of insider trading is not statutorily defined in the Australian statutes. There seems to be less than full agreement with regard to the literal, purposive and legislative interpretation of this concept in Australia. Therefore, the term "insider trading" is not prominently used in the Australian insider trading legislation.[13] The Australian legislature however defined a few terms which constitute or involve insider trading. For example, it defined terms such as *insider*,[14] *inside information*,[15] *material effect*,[16] *person*[17] and *procuring*.[18] Regrettably, other terms such as *tipping*, *tippee*, *tipper* and *generally available* are not statutorily defined in the current insider trading provisions.

However, it is generally accepted that insider trading involves the abuse of or exploitation of non public price-sensitive inside information that relates to a body corporate or its securities for personal gain by any person.[19]

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12 See Jooste R "A critique of the insider trading provisions of the 2004 Securities Services Act" (2006) 123 *SALJ* 437. Also see the discussion in Chapter 4.

13 This is the so-called "fuzzy law" technique that characterises most of the Australian insider trading criminal sanctions. See Lyon G and Du Plessis J J *op cit* note 11 66.

14 See section 1043A (1) of the 2001 Act.

15 See section 1042A of the 2001 Act.

16 See section 1042D of the 2001 Act.

17 See section 1042G and 1042H of the 2001 Act.

18 See section 1042F of the 2001 Act.

19 See Ziegelaar M "Insider Trading Law in Australia" in Walker G, Ramsay I and Fisse B (eds) *Securities Regulation in Australia and New Zealand* LBC Information Services 1998 556-560; Bostock "Australia's New Insider Trading Laws" (1992) 10 *Company and Securities Law Journal* 165 181; Tomasic R *Casino Capitalism? Insider Trading in Australia* Australian Institute of Criminology

Seemingly, the South African Securities Services Act,[20] like its Australian counterpart also does not define the concept of insider trading. Furthermore, the latter Act does not define adequately some of the terms that relate to conduct that constitutes insider trading. It contains for instance, flawed definitions of terms such as *insider*, *person* and *inside information*.[21] Although there are otherwise many similarities between the South African and the Australian insider trading legislation, it is questionable due to the absence of proper definitions, whether the New Act will be as adequate and effective as its Australian counterpart.

7.2.2. The prohibition on "insider trading".

As highlighted earlier, the insider trading prohibition is currently contained in Division 3 of Part 7.10 of the 2001 Act and applies to Division 3 financial products. Division 3 financial products include securities, derivatives, or managed investment products, or superannuation products other than those proscribed by the regulations made for the purposes of section 1042, or other financial products that are capable of being traded on a financial market.[22] Consequently, insiders or any other persons who possess price-sensitive inside information that relates to the securities of a body corporate and who know or ought reasonably to have known that such information was not generally available to the public are prohibited from subscribing for or procuring or purchasing or selling such securities.[23]

Canberra 1991 115-117; Lyon G *An Examination of Australia's Insider Trading Laws* SJD Thesis Deakin University 2003 9-100.

20 Act 36 of 2004. This Act is hereinafter referred to as the "New Act".

21 See Jooste R (2006) *op cit* note 12 438; also see Chapter 4 of this dissertation for detailed analysis.

22 See generally section 1042A of the 2001 Act; Lyon G and Du Plessis J J *op cit* note 11 54-56. Also compare it with section 764 of the *Corporations Law*.

23 See section 1043A of the 2001 Act; Lyon G and Du Plessis J J *op cit* note 11 22-23; O'Brien "Insider Trading Case to test Chinese Walls" *Irish Times* 01 May 2006, on the prospect of the Citigroup Global Capital Market company facing heavy penalties for allegedly practising insider trading amounting to a profit of about Aus $4, 6 billion of (its client) Toll Holdings shares.

It is therefore noteworthy that the prohibition of insider trading in Australia applies to any person as defined or who qualifies to be an insider by virtue of section 1043A (1). Thus, it is plausible to understand the meaning of the term "person". This term is defined to include a body corporate or partnership (juristic persons) as well as a natural person (an individual).[24] It is clear that the insider trading prohibition in Australia has a much wider application than the prohibition in South Africa. It covers explicitly, both juristic and natural persons as well as a wide range of financial products. Furthermore, it also applies to other illicit practices such as tipping. An insider or any other person is specifically prohibited from deliberate, intentional and unlawful communicating (disclosure) of price-sensitive inside information to another person before it becomes generally available to the public (published).[25]

Furthermore, the prohibition of insider trading in Australia has extra-territorial application. The prohibition on insider trading applies to *acts* or *omissions* (unlawful trading) *within Australia* relating to securities of any Australian or *foreign body corporate* as well as to acts or omissions *outside Australia* in relation to the securities of a body corporate that is established or is carrying on business *in Australia*.[26] Thus, all territorial limitations and problems which previously impeded the enforcement of insider trading provisions outside Australia are now solved.[27]

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[24] See section 1042G and 1042H of the 2001 Act.

[25] See comparatively Brand V "Sanctioned 'dobbing': Whistle Blowing under the Corporations Act, 2001(C'th)" http://www.parsons.law.usyd.edu.au/CLTA/BrandPaper.pdf 28 February 2007; Latimer P "Whistleblowing in the Financial Services Sector" (2002) 21 *University of Tasmania Law Review* 39 46; Zipparo L "Encouraging Public Employees to Report Workplace Corruption" (1999) 58 *Australian Journal of Public Administration* 83 88; Liverani M "Cool Reception for Whistleblowing in the Professions" (December 2002) *Law Society Journal* 26; Gobert J and Punch M "Whistleblowers, the Public Interest, and the Public Interest Disclosure Act 1998" (2000) 63 *Modern Law Review* 25 46.

[26] See section 1042B (a) and (b) of the 2001 Act. Also see generally Ford, Austin and Ramsay *Ford's Principles of Corporations Law* Looseleaf service update number 43,9/2004,9338 [9.605].

[27] See *Danae Investment Trust plc v Macintosh Nominees Pty Ltd* (1993) 11 ACLC 273 1242, where the Supreme Court of South Australia previously held that section 128 of the Securities Code did not apply to the purchase or sale of shares in a company incorporated in Australia if such transactions took place

The current insider trading provisions in South Africa also prohibit any "person" (juristic persons and natural persons) from practising insider trading and other related activities such as tipping. Notably, the definition of the term "person" proscribed in section 72 of the New Act also includes a partnership and a trust. This means that a trust or a partnership can be held liable for insider trading. However, unlike in Australia, liability for insider trading can only be incurred by an insider who *knowingly* trades or deals in securities on the basis of the non public inside information that *he or she possesses*.

The South African insider trading prohibition also has unlimited extra-territorial application but its application is not limited to situations where there is a territorial basis. Part of the reason for this is possibly inadequate financial resources to enforce it effectively in South Africa and elsewhere.[28] Perhaps the South African legislature should have adopted a more feasible and practically enforceable approach rather than an over ambitious and unlimited extra-territorial approach in relation to the insider trading prohibition.

7.2.3. The role and effectiveness of the Australian Securities and Investments Commission (ASIC).

The regulation of securities markets in Australia has come a long way. It was introduced by the *Corporations Law* on 1 January 1991 and was administered by a single federal agency or regulatory body, the Australian Securities Commission (ASC).[29] This followed the failure of its predecessor, the National Companies and Securities Commission (NCSC) in the early 1980s to enforce and to ensure compliance by the Australian securities markets and companies.[30]

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elsewhere. In this case it was further held that section 128 did not apply to transactions which took place in the United Kingdom.

28 See Jooste R (2006) *op cit* note 12 453.

29 See Adams M and Freeman M "The Securities Market in Australia" in Walker G and Fisse B (eds) *Securities Regulation in Australia and New Zealand* Oxford University Press 1994 141-145.

30 *Ibid*; Comino V "National Regulation of Corporate Crime" (1997) 5 *Current Commercial Law* 84. Also see generally Tomasic R "Corporations Law Enforcement Strategies in Australia: The Influence

The ASC was renamed ASIC on 1 July 1998.[31] ASIC has several responsibilities which include among other things, to investigate any criminal matters involving corporate law (such as insider trading) and to prosecute such matters in terms of the ASIC Act of 2001[32] and the 2001 Act[33] respectively. ASIC is, in relation to criminal matters, empowered further, to refer any serious or complex matter to the Commonwealth Director of Public Prosecutions (DPP) for prosecution in accordance with a Memorandum of Understanding (MOU) between itself and the DPP.[34]

ASIC also has powers to disqualify any person convicted of insider trading from his or her directorship or managerial position in any company or corporation.[35] Furthermore, it has powers of search and seizure of any proceeds in relation to any benefits that may result from insider trading activities.[36] It is further responsible for maintaining, facilitating and improving the performance of companies, securities markets and futures markets. Thus, ASIC has a major role to play in maintaining confidence of investors in securities markets and futures markets by ensuring adequate protection of such investors,[37] for the purpose of enhancing commercial stability, efficiency, the development of the economy and generally reducing business costs.

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of Professional, Corporate and Bureaucratic Cultures" (1993) *Australian Journal of Corp Law* 192 197.

31 See generally Comino V "High Court Relegates Strategic Regulation and Pyramidal Enforcement to Insignificance" http://www.parsons.law.usyd.edu.au/CLTA/CominoPaper.pdf 28 February 2007.

32 See section 49 of the Asic Act (C'th).

33 See section 1314 of the 2001 Act.

34 See generally Tomasic R "Sanctioning Corporate Crime and Misconduct: Beyond Draconian and Descriminalisation Solutions" (1992) 2 *Australian Journal of Corp Law* 82 102-105.

35 See in detail *R v Rivkin* (2003) 198 ALR 400 406 where one Rivkin was disqualified from managing any corporation or company for 5 years and fined Aus $30 000.

36 See *R v Hannes* (2002) 43 ACSR 508 529 where ASIC seized Aus $2 million's worth of unlawful insider trading profits from the accused, Mr Hannes.

37 See generally Shaw A and Von Nessen P "The Legal Role of the Australian Securities Commission and The Australian Stock Exchange" in Walker G, Ramsay I and Fisse B (eds) *Securities Regulation in Australia and New Zealand* LBC Information Services 1998 163-164. Also see De Marzo P M,

With regard to civil remedies and sanctions, ASIC may in the public interest, bring an action in the name of and for the benefit of the body corporate to recover its losses or entitlements as contemplated in section 1043L(2) or (5). This is usually done in instances where the issuer's board of directors is unable or unwilling to pursue those proceedings to utilize their civil remedies. Therefore, ASIC may institute a civil action for insider trading without the consent of the affected persons or the issuer of the affected securities.[38]

ASIC may also apply for a compensation order on behalf of any person who was prejudiced by unlawful insider trading.[39] Furthermore, ASIC may seek court orders such as restraint, investment, mandatory direction and cancellation orders to ensure timely compensation for the victims of insider trading[40] and is empowered to apply for a civil penalty by way of a pecuniary penalty. A pecuniary penalty is a penalty imposed only after a declaration of contravention of a financial services penalty provision has been proved in a court of law.[41]

Although the role of ASIC as a corporate watchdog against insider trading and related practices has been criticised by some commentators for being ineffective,[42] many successful cases have been reported to date that serve as proof of ASIC's efficiency. At

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Fishman M J and Kathleen M H "The Optimal Enforcement of Insider Regulations" (1998) Vol 106 No 3 *The Journal of Political Economy* 602 606.

38 See Lyon G and Du Plessis J J *op cit* note 11 125. Also see "ASIC Commences Civil Proceedings Against former One.Tel Officers and Chairman" *ASIC Media Release* 01/441 12 December 2001 and "Landmark Decision on Chairman's Duties" *ASIC Media Release* 03/068 24 February 2003.

39 See sections 1317J and 1325 of the 2001 Act.

40 See section 1043O of the 2001 Act; *ASIC v Petsas* [2005] FCA 88.

41 See *ASIC v Adler* (2002) 42 ACSR 80 115 and *Rich v ASIC* (2004) 209 ALR 271.

42 See Comino V *op cit* note 30 84. Also see "Brad Keeling Settles in ASIC One. Tel Proceeds" *ASIC Media Release* 03/099 21 March 2003; Ferguson A "The Watchdog No one Fears" (2000) 1 *BRW* 58.

least five persons were for instance recently convicted of insider trading as a result of the functioning of ASIC and the courts.[43]

It is noteworthy that the South African legislation, unlike the legislation of Australia, does not provide for a right of action by the *issuers of securities*. Regrettably, it rigidly and solely imposed the responsibility for taking action on the FSB. It is submitted that if the Australian approach in this regard is followed it may lead to more effective curbing of insider trading in South Africa.[44]

7.2.4. Establishment of competent courts to prosecute insider trading cases.

The courts play an important role in the enforcement of insider trading legislation in Australia. Both the High and Supreme Courts of Australia have inherent powers to impose sanctions and penalties on any person who contravenes the insider trading provisions.[45] These powers include the making of orders restraining any accused persons to exercise rights attached to Division 3 financial products, orders to restrain the acquisition, issue or disposal of such products, orders for the vesting of such products in ASIC or to direct the disposal of such products, or orders for the cancellation of Australian financial services licences.[46] Some commentators submit that the courts also have powers to make orders that direct any person to do or refrain from doing specified

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43 See Lyon G and Du Plessis J J *op cit* note 11 *Appendix 1 Table of Australian Insider Trading Cases* 199. Also see *ASIC v Adler* (2002) 42 ACSR 80 97-99; *ASIC v Rich* [2003] NSWSC 186; *ASIC v Loiterton* [2004] NSWSC 897 and *ASIC v Petsas supra* note 40.

44 See Jooste R (2006) *op cit* note 12 458-459.

45 See section 1043O of the 2001 Act.

46 See further Baxt R, Black A and Hanrahan P *op cit* note 5 546. Also see Mann K "Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law" (1992) 10 *The Yale Law Journal* 1795 1845; "ASIC Restrains Rich Assets" *ASIC Media Release* 01/199 8 June 2001; "ASIC Obtains Court Undertakings Freezing Assets of former One. Tel Managers" *ASIC Media Release* 01/343 24 September 2001; "Jodee and Maxine Rich Asset Transfer Agreement" *ASIC Media Release* 03/362 13 November 2003.

acts, for purposes of ensuring compliance with any other order it may make in this regard.[47]

The success achieved by the Australian courts in relation to the effective enforcement of the insider trading provisions is clearly reflected in the number of reported settlements and prosecutions recorded in both civil and criminal cases to date.[48] The Australian courts have in fact been commended for effectively enforcing the insider trading prohibition.[49] They do not only rely on circumstantial evidence to impute liability on accused persons, but also take cognisance of other relevant factors, such as actual abuse of material non public price-sensitive inside information by an insider or any other person for personal benefit or for another.

Notwithstanding the fact that South Africa also empowers the High Courts or in relation to criminal prosecutions, also the Regional Courts to hear any matter of insider trading and related prohibited practices,[50] the absence of settlements and successful prosecutions suggests that these courts are not effectively fulfilling this function. This is a major

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47 See generally Kluver J "Insider Trading" http://www.camac.gov.au 04 January 2007. Also see the Corporations and Markets Advisory Committee (CAMAC) *Insider Trading Report* (November 2003) <http://www.camac.gov.au/camac.nsf/byHeadline/PDFFinal+Reports+2003/$file/Insider_trading_Report_Nov03.pdf> 12 December 2006; section 1043O of the 2001 Act.

48 See for example *ASIC v Saddey* (1991) 9 ACLC 874; *Exicom v Futuris* (1995) 13 ACLC 1758; *ASIC v Kippe* (1996) 67 FCR 449; *Ampolex v Perpetual Trustee Company (No 2)* (1996) 14 ACLC 1514 1524; *ASIC v Donovan* (1998) 28 ACSR 583 608; *ASIC v Roussi* [1999] FCA 618; *R v Hannes* (2000) 36 ACSR 72 120; *ASIC v Hutchings* (2001) 38 ACSR 387; *R v Firns* [2001] 51 NSWLR 548; *ASIC v Adler supra* note 41; *ASIC v Rich* (2003) 45 ACSR 305; *R v Rivkin* [2004] NSWCCA 7 17; *ASIC v Pestas supra* note 40. Also see Tomasic R "Corporate Crime and Corporations Law Enforcement Strategies in Australia" Discussion Paper 1/93 Center for National Corporate Law Research Canberra (1993) 17 70; Cox D "An Economic and American Perspective of Insider-trading Regulation in Australia and New Zealand" in Walker G and Fisse B (eds) *Securities Regulation in Australia and New Zealand* Oxford University Press 1994 621-637.

49 See the Australian Law Reform Commission *Principled Regulation: Federal Civil and Administrative Penalties in Australia Report No 95* (2002) 113; Lyon G and Du Plessis J J *op cit* note 11 163-166; Comino V *op cit* note 30 84.

50 See section 79(1) of the New Act.

concern of many investors and other persons and it is generally agreed that the lack of successful prosecutions or settlements in South Africa is a problem that is caused exclusively by the legislature's rigid adoption of contemporaneous American insider trading principles.[51] Instead of engaging many regulatory agencies (bodies) and fully empowering the courts to enforce the prohibition on insider trading, only the FSB has such inherent powers.[52] Worse still, neither the courts nor the FSB has sufficient and adequate resources to ensure effective enforcement. The South African legislature would be well advised to consider some of the helpful lessons that can be learned from the Australian regulatory experience in order to strengthen its own regulatory and enforcement framework.

7.2.5. Reliance on both civil and criminal sanctions.

It is acknowledged in Australia that for purposes of achieving the best results, the remedies for violating insider trading provisions and the criminal sanctions fall in three categories, namely criminal penalties, civil remedies and civil penalties.[53] Each of these three categories will be discussed under this sub heading to determine and assess their effectiveness. It will also be analyzed comparatively, why the Australian model is more successful than that of South Africa.

With respect to criminal sanctions, liability for contravention of the insider trading prohibition proscribed in section 1043A stems from section 1311(1). Any person who contravenes section 1043A will be guilty of the insider trading offence. The discretion to institute criminal proceedings on an indictment for insider trading is vested in ASIC and the DPP.[54]

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[51] The so-called US approach; see Jooste R (2006) *op cit* note 12 460 (summary and concluding remarks).

[52] See Lyon G and Du Plessis J J *op cit* note 11 137.

[53] See Lyon G and Du Plessis J J *op cit* note 11 107.

[54] This is done in accordance with a memorandum of understanding between the DPP and ASIC which was signed on 22 September 1992. See *ASIC Digest* Vol 4 (3603) 3330; *ASIC Digest* Vol 1 (1047) 58.48. Also see generally section 1316 of the 2001 Act; Commonwealth Director of Public Prosecutions *The Decision to Prosecute*: *The Policy of the Commonwealth* (2003) [2.28]

Although no specific provision of the 2001 Act imputes criminal liability on accessories (aiders or abettors) who deliberately engage themselves in insider trading, such persons may still be liable in terms of the *Criminal Code* which applies to all contraventions of Commonwealth Acts.[55] This *Criminal Code* stipulates that a person who aids, abets, counsels or procures the commission of an offence is regarded to have actually committed that offence and is sentenced accordingly even where the principal offender has not been prosecuted or convicted.[56]

Penalties for contravening the insider trading provisions are stipulated in Schedule 3 of the 2001 Act.[57] For example, where an individual (natural person) is convicted of insider trading, he would be liable for a fine up to 2000 penalty units (Aus $200,000) or a maximum sentence of five years imprisonment.[58] A body corporate may, if it is convicted, be fined up to 10,000 penalty units (Aus $1million) and in addition, to a maximum fine of up to five times the pecuniary penalty.[59]

In addition, where the convicted person has managed a company or corporation, that person is automatically disqualified from performing his or her duties for a period of five years from the date of conviction or release from prison. Again, ASIC may increase this period by applying to a court for a longer disqualification or banning order where it is justified by exceptional circumstances.[60]

<http://wwww.cdpp.gov.au/Prosecutions/Policy> 12 January 2006 and *Kovess v Director of Public Prosecutions* (1998) 74 FCR 297. See further *Attorney-General (C'th) v Qates* (1999) 198 CLR 162.

55 See *Criminal Code* (C'th) Part 2.4 Division 11; section 11.22 and section 11.2(5).

56 The so-called ancillary liability. See sections 1370 and 1384 of the 2001 Act; Lyon G and Du Plessis J J *op cit* note 11 109.

57 See 2001 Act Schedule 3 items 311B and 311C.

58 See *R v Hannes supra* note 36.

59 See section 1312 of the 2001 Act; *Kovess v Director of Public Prosecutions supra* note 54. Also see generally Watson I and Young A "A Preliminary Examination of Insider Trading Takeover Announcements in Australia" (June 1998) http://www.google.com 17 March 2006.

60 See *ASIC v Rich* [2003] NSWSC 186.

Where a person has been convicted of insider trading, the prosecutor on behalf of the DPP may make an application for forfeiture of any benefit derived from the trading. The proceeds being the amount of illicit profit made, may be forfeited through the intervention of the DPP and the courts.[61]

The 2001 Act also provides for civil sanctions and penalties imposed on those who practise insider trading. It is therefore important to note that the civil remedies are twofold in nature. Any person who violates the insider trading provisions will firstly be liable to compensate any other person who falls victim to insider trading or tipping, for his losses.[62] Secondly, a civil penalty is provided for in section 1317HA. The actions for compensation and to impose a penalty must be instituted within 6 years of the arising of the cause of action.[63]

Although it appears that tipping another person as contemplated in section 1043A(2) does not lead to an action for compensation under section 1043L, various circumstances are specifically provided for in section 1043L(2)-(5) under which such an action may be brought against an insider or any other person whose conduct amounts to tipping.

These provisions enable an uninformed purchaser, the issuer of securities and ASIC to invoke the civil proceedings in a number of ways.

Firstly, the *issuer* of the securities or financial products is entitled to recover any damages suffered by him from the insider or from any person who applies or procures another to apply for financial products as contemplated in section 1043L (2). The damages will then comprise the difference between the application price and the price that could have been asked if the information had been available to the public at the time of application. The issuer of financial products has additional rights provided for in section 1043L (5).

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61 See sections 19(1) and 43 of Proceeds of Crime Act of 1987 (C'th); *R v Rivkin* supra note 35 and *R v Hannes supra* note 36 519.

62 See section 1043L of the 2001 Act.

63 See section 1317K of the 2001 Act.

For example, if such products were the subject matter of an affected transaction, the issuer in question may also recover the loss incurred.[64] This implies that an insider or any person who contravenes the provisions may incur civil liability where the securities in question have been purchased or sold.[65]

Secondly, the *uninformed purchaser* or any *person who disposes of a financial product* may recover his loss suffered, from an insider or any other person who purchases the disposer's financial products.[66] Lastly, as pointed out earlier, ASIC may, where it considers to be in the public interest, bring an action in the name of and for the benefit of any affected body corporate to recover civil damages.[67]

Noteworthy, in South Africa like in Australia both civil and criminal sanctions are imposed to curb insider trading and interestingly, the South African legislation now also covers juristic persons.[68] However, unlike the position in Australia, there is no distinction between the penalties and sanctions that are imposed on individuals and juristic persons in South Africa.[69] Moreover, there is no statutory duty on the part of insiders in South Africa to disclose their transactions pertaining to securities or other instruments issued by their companies or other institutions,[70] or any express duty on companies or institutions to disclose their unpublished price-sensitive inside information to the public. This unfortunately also means that there are no appropriate sanctions for such non-disclosure.

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64 See further section 1043L (3) and (4) of 2001 Act.

65 See Ford, Austin and Ramsay *Ford's Principles of Corporations Law* looseleaf service update 43, 9/2004 9406 [9.690]. Also see *Keygrowth Ltd v Mitchell* (1990) 3 ACSR 476 487.

66 See for detail section 1043L (3) of the 2001 Act.

67 See paragraph 7.2.3 above for a detailed analysis of the role of ASIC. Also see section 1043L (2) and (5) of the 2001 Act; *ASC v Forem Free-way Enterprises Pty Ltd* (1999) 30 ACSR 339 351; Welsh "The Corporations Law Civil Penalty Provisions and the Lessons Learned from the Trade Practices Act 1974" (2000) 11 *Australian Journal of Corporate Law* 299.

68 For the position in South Africa see sections 73 and 77 of the New Act.

69 For the position in South Africa see section 115(a) of the New Act.

70 See Jooste R (2006) *op cit* note 12 452.

On the other hand, although it appears that the civil sanctions of Australia might be somewhat inadequate and that the penalties for criminal offences are not severe, the significant number of successful insider trading cases reported to date points to the fact that such sanctions are at least effectively utilized. It is against this background that the researcher submits that meaningful lessons can be learned from Australian law in relation to the campaign against insider trading.

7.2.6. The adequacy of available defences and exceptions.

The Australian insider trading regulatory framework offers several exceptions and defences that are specifically formulated to relieve insiders or other persons from incurring liability in instances where their actions or conduct would otherwise amount to insider trading or tipping. It is therefore important to determine how such defences and exceptions are utilized in Australia.[71]

It appears the term "exception" is used in some of the provisions that apply to curtail liability in both criminal and civil proceedings,[72] while the term "defences" is mostly used in relation to criminal proceedings only.[73] Interestingly, these terms seem to be used interchangeably in the current regulatory framework in Australia.[74]

The onus of proof of these defences and exceptions lies upon the alleged insider or any person who is alleged to have contravened the insider trading provisions. Furthermore, the prosecution is not required to prove the non-existence of the facts or instances which

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71 For purposes of this sub-heading, this analysis is done mainly with reference to the 2001 Act. Other defences and exceptions that are provided for in the *Corporations Regulations Act* (C'th) of 2001 will not be referred to in detail.

72 See sections 1043B-1043K of the 2001 Act.

73 See section 1043M of the 2001 Act.

74 See section 1043M (1) of the 2001 Act with a sub-heading called "Defences to Prosecution for an Offence", but nonetheless it expressly discusses the exceptions proscribed in section 1043B-1043K of the same Act. Also see the CAMAC *Insider Trading Report supra* note 47.

stop such provisions from being applicable.[75] The accused is required to prove any of the proscribed defences or exceptions on a balance of probabilities.[76] Firstly, the exceptions will be discussed and thereafter, the defences.

With regard to the exceptions, the first one entails that the prohibition on insider trading does not preclude members of a body corporate`s registered managed investment scheme from withdrawing, if on such withdrawal they receive a payment determined by valuating the underlying value of the assets even if the institution (company) in question has non public price-sensitive inside information at the time of redemption.[77] The registered managed investment scheme is a scheme on property for all approved members. For example, it may involve buying or selling of property which would have a material effect on the value of the interests in the scheme in question.

The second exception relates to the purchase of securities in fulfillment of a legal obligation imposed in terms of the 2001 Act.[78] Examples of situations in which an obligation to repurchase shares may arise are:

- the acquisition of shares from shareholders dissenting from a scheme or contract approved by the majority shareholders;[79]
- the right of remaining securities holders to require a bidder to acquire their shares in certain circumstances;[80]
- and the right of remaining convertible securities holders to require a bidder to acquire their shares in certain circumstances.[81]

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75 Section 1043M of the 2001 Act. Also see *Securities Ltd v National Companies and Securities Commission* (1990) ACSR 796.

76 See section 13.5 of the *Criminal Code* (C'th).

77 See sections 1043B; 601GA (4); 601FC and 601MA of the 2001 Act.

78 See Ziegelaar M *op cit* note 19 556 582 and section 1043D of the 2001 Act.

79 See section 414 of the 2001 Act.

80 See section 662A-662C 2001 Act.

81 See section 663A of the 2001 Act; also see analysis by Lyon G and Du Plessis J J *op cit* note 11 78.

However, it should be noted that this exception does not apply to discretionary purchases, for instance where a corporation or a company exercises its discretionary powers in implementing a buy-back scheme or in the event of a compulsory acquisition of securities.[82]

Thirdly, an underwriter or sub-underwriter who has unpublished price-sensitive inside information is exempted from insider trading liability if he:

(i) applies for, acquires securities or manages investment products under an underwriting agreement or sub-underwriting agreement; or

(ii) disposes of securities or managed investment products acquired under such agreement; or

(iii) enters into an underwriting or sub-underwriting agreement.[83]

Thus, for purposes of this exception, an underwriter or sub-underwriter may disclose inside information to procure any person to enter into an underwriting agreement in relation to any such securities or managed investment products or to enter into a sub-underwriting agreement in relation to such similar products or securities.[84]

Fourthly, the prohibition against communication (tipping) of inside information is not applicable in instances where such tipping was in line with a legal requirement imposed by the Commonwealth, a State, a Territory or any other recognized regulatory authority.[85] This exception was enacted to enable unpublished price-sensitive inside information to be lawfully disseminated by any person who possesses it to either ASIC or the Australian Stock Exchange (ASX).[86]

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82 See sections 414(2) and 664A (2) of the 2001 Act.

83 See section 1043C (1) of the 2001 Act.

84 See Lyon G and Du Plessis J J *op cit* note 11 76. Also see *Hooker Investments Pty Ltd v Baring Halkerston and Partners Securities Ltd* (1986) 10 ACLR 462 467.

85 See section 1043E of the 2001 Act.

86 See *Explanatory Memorandum Corporations Legislation Amendment Bill of 1991(C'th)* 100 350.

Fifthly, perhaps one of the most important exceptions ever to be promulgated by the Australian legislature entails Chinese Walls.[87] This exception protects corporate entities,[88] partnerships and dealers who trade in securities in instances where a company officer, employee, security dealer[89] or member of a partnership[90] or an agent has or is deemed to have unpublished price-sensitive inside information relating to the affected securities.[91]

However, for any such persons to rely on the Chinese Wall exception, they must satisfy the following four requirements:

- The decision to enter into an agreement should have been taken by a person other than the officer or employee who has the non public material inside information.
- The entities must have in place structures (Chinese Walls) which can objectively be expected to ensure that such inside information is not prematurely disclosed to the person or persons who then trade on that information.
- These structures must also ensure that such persons do not communicate (tip off) with any other person to trade on the premise of the inside information so disclosed and that relates to the affected transaction.
- Persons tipped off should not have been forced or coerced to trade or enter into any transaction.

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87 See Goldwasser "Recent Developments in the Regulation of Chinese Walls and Business Ethics" (1993) 17 *Company and Securities Law Journal* 227 228.

88 See section 1043F of the 2001 Act.

89 See section 1043K of the 2001 Act.

90 See section 1043G of the 2001 Act.

91 See Lyon G and Du Plessis J J *op cit* note 11 80-82, for a detailed analysis of the Australian Chinese Walls exception; see also paragraph 4.5 of Chapter 4 for the researcher's analysis. See however Cassim R "Some Aspects of Insider Trading – Has the Securities Services Act, 36 of 2004 Gone too Far?" (2007) 19 *SA Merc LJ* 44 46-54 for her objections and criticisms of the Chinese Wall defence.

Lastly, the Australian legislation also exempts individuals, bodies corporate,[92] bodies corporate in respect of the conduct of their employees or officers[93] and officers of bodies corporate[94] from any liability in respect of their knowledge and intentions pertaining to certain share transactions that they may undertake. This exception enhances multiple trading in the securities of a body corporate irrespective of the fact that trading in such securities may result in the price of such securities being materially affected.[95]

The *statutory defences* against insider trading liability are provided for in section 1043M of the 2001 Act which also provides that the onus of proof rests on the accused or the defendant to prove any of the proscribed defences. There are generally two defences which are provided for in section 1043M (2) and (3) respectively.

Firstly, there is the so-called publication defence which entails that no person is liable for insider trading or tipping if the price-sensitive inside information that relates to the affected securities is acquired after it has been made available to the public (published)[96] in a manner known or common to investors of such securities and if a reasonable time since disclosure has elapsed. This also applies where the persons involved have or ought reasonably to have the same information affecting the securities in question.[97] Interestingly in this respect, is the fact that the Australian provisions seem to allow persons to trade or to tip others to trade on the basis of such information when they have become aware that it has been published already.

Secondly, any person accused of insider trading or tipping may be exempted from liability if he proves that the other party to the transaction in question knew or ought reasonably to have known about the inside information before entering into the

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92 See section 1043I (1) of the 2001 Act.

93 See section 1043(2) of the 2001 Act.

94 See section 1043J of the 2001 Act.

95 See *Australian Mining Industries v King* [2002] NSWSC 1033. Also see Lyon G and Du Plessis J J *op cit* note 11 94.

96 See section 1042C (1)(b) of the 2001 Act.

97 See sections 1043M (2)(a) and (3)(a) of the 2001 Act.

transaction or before tipping has occurred.[98] Although it is not clear what exactly constitutes equal information or when such information can be said to have been equally available to the parties involved, this defence is well recognized in the Australian courts.[99]

However, the Australian legislature should have enacted more defences to supplement the proscribed exceptions to avoid affecting innocent persons and creating an over-regulation problem.[100] Despite this shortcoming,[101] it is generally acknowledged that the awareness and reliance on the existing exceptions and defences has objectively speaking, been successful.[102]

Apparently, the current South African statute also provides for defences which are devised to prevent innocent persons from incurring insider trading liability. However, unlike the position in Australia, there are no "exceptions" to supplement the proscribed defences. Perhaps, the legislature should have made provision for exceptions in addition to the defences.[103]

Furthermore, as is argued by Jooste, no effort has been made to preserve or to enforce the common law defences.[104] He argues that the current provisions should have expressly preserved common law defences. Although it may be said that according to the South

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98 The so-called equal information defence. See section 1043M (2) and (3) of the 2001 Act; Lyon G and Du Plessis J J *op cit* note 11 100.

99 See *CLC Corporation v Cambridge Gulf Holdings NL* (1997) 25 ACSR 296.

100 See comparatively Lyon G and Du Plessis J J *op cit* note 11 102-103 and Kluver J *op cit* note 47.

101 See generally Gething "Insider Trading Enforcement: Where are We Now and Where do We Go from Here?" (1998) 16 *Company and Securities Law Journal* 607 and Anisman P "Insider Trading Legislation in Australia: An Outline of the Issues and Alternatives Report (1986) 81-86.

102 See for instance, *Hook Investments Pty Ltd v Baring Bros Halkerston and Partners Securities Ltd* (1980) 10 ACLR 524 NSWCA, *Ampolex v Perpetual Trustee Company (Canberra) Ltd (No 2)* (1996) 14 ACLC 1514, *R v Evans* [1999] VSC 488 and *R v Hannes* (2000) 36 ACSR 72.

103 See paragraph 4.5 of Chapter 4 of this dissertation for a detailed analysis on the adequacy of such defences.

104 See Jooste R (2006) *op cit* note 12 450.

African common law principles such defences are regarded as valid and enforceable unless they have been expressly excluded by statute, the legislature should have enacted these and additional defences to protect persons who inadvertently become involved in insider trading from possible draconian effects of insider trading legislation.

7.2.7. The enforcement of insider trading legislation and the effectiveness of the Australian insider trading regulatory framework.

The interrelationship between various insider trading enforcement agencies in Australia will be examined, by focusing on relevant factors such as detection, prevention and prosecution of insider trading and related activities. Finally, a comparative analysis of the South African and Australian regulatory frameworks will be made.

Although it appears that the Australian regulatory framework comprises mainly of ASIC, the ASX and the courts, other self regulatory organs (SRO's) such as Australian Competition and Consumer Commission (ACCC), Corporations and Markets Advisory Committee (CAMAC), International Banks and Securities Association of Australia (IBSA), Securities and Derivatives Industry Association (SIASDIA) are also involved and systems such as the Stock Exchange Automatic Trading System (SEATS) and Clearing House Electronic Sub-register System (CHESS) are also implemented. Each of these regulatory bodies and systems will therefore be discussed.

ASIC is regarded as the principal organ that ensures effective combating of insider trading in Australia. It also operates a system for Electronic Document Lodgment (EDGE). This system enables lodgment agents such as accountants, lawyers and brokers to promptly transfer relevant documents to ASIC electronically and free of charge to effect disclosure of inside information. It is generally agreed that ASIC has to date successfully performed its role as a "corporate watchdog" as well as a body that enforces the insider trading prohibition.[105]

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[105] See paragraph 7.2.3 of this Chapter for a detailed and elaborate discussion on the adequacy of ASIC.

It should be borne in mind that ASIC does not work in isolation. The courts are also involved in the enforcement of the insider trading legislation. These courts, as was highlighted earlier in paragraph 7.2.4, have generally managed to curb insider trading and related activities such as tipping effectively. They have, for example, in most cases and in pursuance of their discretion, adopted some practical guidelines to supplement the insider trading provisions.[106]

Another body that monitors and regulates insider trading and related activities is the ASX. The establishment and statutory recognition of the ASX commenced in the early 1970`s.[107] This follows the adoption of the recommendations in the report of the Senate Select Committee on Securities and Exchange which was chaired by Senator Rae in 1974.[108] In April 1987, the ASX was created to replace the Australian Associated Stock Exchange, to consolidate six former state Exchanges and to formulate a national exchange which has since been the only operating stock exchange in Australia.[109]

The principal function of the ASX is to provide and to maintain an efficient, informed and fair trading securities market. Thus, the ASX is responsible for ensuring that Australian securities markets are free from any manipulative and unfair practices such as insider trading. Moreover, the ASX offers a number of services to the markets such as fair trading systems, control of market integrity, guarantees of trade completion and to supply relevant information pertaining securities trading, settlement and transfer systems.[110] More specifically, such services include the Company Announcements Platform (CAP). CAP was introduced by the ASX in August 1995 to assist companies to lodge announcements by facsimile to the ASX from any place in Australia at a

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[106] For an incisive analysis, see paragraph 7.2.4 of this Chapter.

[107] See Shaw A and Von Nessen P *op cit* note 37 161.

[108] *Australian Securities Markets and their Regulation* Senate Select Committee on Securities and Exchange Report of 1974. Hereinafter referred to as the Rae Report.

[109] See Part IIA of the Australian Stock Exchange and National Guarantee Fund Act of 1987. Also see Shaw A and Von Nessen P *op cit* note 37 174. For further comparative reading see Mitchell P L R *Insider Dealing and Directors' Duties* 2nd ed Butterworths 1989 232-260.

[110] See the ASX Annual Report 1996 2.

reasonably cheap cost. This service was introduced to encourage companies to comply with prompt disclosure requirements of any inside information that relates to securities.

Another service offered by the ASX is the SEATS system which was established in 1987 and became fully operative in 1990.[111] Its main role is to enable the ASX member organizations with recognized or confirmed orders to buy and sell securities that are traded on a market conducted by the ASX. It also provides its member organizations with adequate information pertaining securities market trading such as any changes in the market. This avoids abuse of non public price-sensitive information relating to securities, by any person who might have access to such information.[112]

In order to complement and supplement the SEATS system, the CHESS system was put in place in September 1994 by the ASX Settlement and Transfer Corporation (ASTC), a wholly owned subsidiary of the ASX, for expedient electronic settlement in Australia of share transfers of both domestic and foreign issuers.[113]

Probably, one of the major services offered by the ASX is the electronic market surveillance. This surveillance is done by way of monitoring market activity and trading patterns through a computerized and sophisticated system called the Surveillance of Market Activity (SOMA). It is submitted that the SOMA system detects abnormal trading sequences by looking at the electronic signal of the SEATS system which contains the details of trading and some programmed parameters in order to alert persons such as financial analysts for consideration. These parameters are programmed to ignore normal trading activity but to immediately record and report any abnormal or irregular trading activity when such parameters are violated.[114]

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111 *Ibid* 8.

112 See Simpson A "Securities Regulation for the Information Age" in Walker G, Ramsay I and Fisse B (eds) *Securities Regulation in Australia and New Zealand* LBC Information Services 1998 37.

113 *Ibid* 39-40.

114 See Australian Stock Exchange *ASX Surveillance: Helping to Protect the Australian Share Market for all Participants* (undated pamphlet). See further Simpson A *op cit* note 112 37. Also see Hannigan

Apart from the ASX, CAMAC also plays a pivotal role in the enforcement of the insider trading legislation in Australia.[115] CAMAC was established in terms of Part 9 of the ASIC Act of 1989 as an advisory body to the government, which is responsible for monitoring insider trading activity and enforcing the insider trading provisions in Australia. Commentators agree that CAMAC has to date made a number of useful proposals for reform of the insider trading regulatory framework.[116] Perhaps, this explains why many successful prosecutions of insider trading were achieved in Australia.

Lastly, the other regulatory authorities involved in the enforcement of the insider trading prohibition are the SRO's. For the purposes of this Chapter, these organizations include IBSA, ACCC and SIASDIA. Their role is to regulate market transactions, market participants and listing of securities. They are further responsible for dispute resolution. Moreover, they have formulated various guidelines for persons involved in the securities business such as brokers and other market participants such as financial analysts. These guidelines are aimed at maintaining market integrity and investor confidence.[117]

The South African regulatory framework, on the other hand, comprises mainly of the FSB and the courts. Regrettably, the South African legislature rigidly imposed the enforcement and regulatory powers on the FSB. The FSB has a mandatory task to refer criminal matters to the courts for prosecution, but unfortunately, it has to date failed to fulfill this task.[118] Although it may be argued that the Johannesburg Securities Exchange

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B *Insider Dealing* 2nd ed Longman Group Ltd 1994 20-46, for an incisive comparative analysis on the detection and surveillance of insider trading and tipping.

115 See Lyon G and Du Plessis J J *op cit* note 11 10. Prior to 11 March 2002 CAMAC was known as Companies and Securities Advisory Committee (CASAC), see http://www.camac.gov.au 08 March 2007.

116 See various references in note 46.

117 For a more detailed analysis see IBSA "Avoiding Conflicts of Interest: A Guide for the Financial Services Industry" (1989) and SIASDIA "Best Practice Guidelines for Research Integrity" (2001) <http://www.securities.edu.au/cms/data/live/files/891.pdf> 22 February 2006. Also see Shaw A and Von Nessen P *op cit* 37 181.

118 See paragraphs 4.6.1 and 4.6.3 of Chapter 4 of this dissertation.

(JSE), through its surveillance department, is also involved in the enforcement of the insider trading ban, interaction and co-operative effort between the JSE, the courts and the FSB can be increased to combat insider trading.

7.3. CONCLUDING REMARKS.

The current Australian insider trading legislation is aimed at promoting market integrity and public investor confidence. To attain this goal, the Australian legislature adopted a number of statutes, policies, recommendations and other necessary measures.

The "*information connection only approach*" is used. It defines an insider as any person who has non public price-sensitive inside information relating to financial products (securities). Such persons are then prohibited from unlawful trading in any securities (insider trading and tipping) on the premise of such information to avoid prejudice to other persons who did not have access to it.

Moreover, the Australian insider trading prohibition contains *mandatory disclosure requirements* for all issuers of securities and affected persons to ensure that all market participants have *equal access* to price-sensitive inside information relating to such securities.

Furthermore, the enforcement of the insider trading prohibition in Australia is not necessarily contingent upon a single regulatory body such as ASIC. It involves a co-operative effort of a number of regulatory and other bodies that compliment ASIC in curbing insider trading and tipping.

The South African regulatory framework, on the other hand, seems to be far from being adequate and effective, due to for example, the absence of other regulatory bodies that are statutorily obliged to assist the FSB and the courts, such as the Bond Exchange of South Africa (BESA), JSE or for that matter the government.

This is perhaps, at least in part, the reason for the many instances of insider trading that could have gone undetected in South Africa and the small number of cases that have actually been reported.[119] Furthermore, unlike the position in Australia, there is no duty (mandatory disclosure requirements) on any person or company to disseminate non public inside information relating to instruments or securities.[120] Therefore, as Jooste lamented, the absence of such disclosure requirements increases the risk of insider trading and other prohibited conduct such as tipping.[121]

In conclusion, this Chapter will hopefully assist the South African legislature to recognize the shortcomings of the New Act and to learn from the Australian experience. Plausibly, as Huang[122] purports, "the Australian 'information connection only approach' to the definition of insiders is both theoretically justifiable and practically manageable". The researcher concurs with Huang and submits that instead of rigidly following US insider trading principles,[123] the legislature should consider to follow the Australian approach in order to make its insider trading legislation adequate, effective and more compatible to international best practice.

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119 See various authorities quoted in note 117.

120 See Jooste R (2006) *op cit* note 12 452.

121 *Ibid.*

122 See Huang H *op cit* note 1.

123 See Chapter 5 of this dissertation.

CHAPTER EIGHT

CONCLUSIONS AND RECOMMENDATIONS TO SOLVE THE INSIDER TRADING PROBLEM IN SOUTH AFRICA.

8.1. GENERAL OBSERVATIONS.

While the attempt made by the legislature to improve the insider trading legislation by replacing the Insider Trading Act, 135 of 1998 (the 1998 Act) with the Securities Services Act, 36 of 2004 (the New Act) was commendable, previous flaws were repeated[1] and new ones were unfortunately introduced.[2] It is clear from the previous discussion, specifically in Chapter 4, that the legislature's good intentions with the adoption of the New Act are not also reflected in an increase of prosecutions and claims being resolved or settled.[3]

This Chapter seeks to recommend possible solutions to the insider trading problems in South Africa. It is hoped that such recommendations will help the legislature to succeed in its insider trading regulatory endeavors and to ensure that insider trading legislation is put in place that is comparable to the international best practices, to protect and attract investors.

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1 See Jooste R "Insider Dealing in South Africa" (1990) 107 *SALJ* 588; Luiz S M "Prohibition Against Trading on Inside Information – The Saga Continues" (1990) 2 *SA Merc LJ* 328; Botha D "Control of Insider Trading in South Africa: A Comparative Analysis" (1991) 3 *SA Merc LJ* 1; Jooste R "The Regulation of Insider Trading in South Africa – Another Attempt" (2000) 117 *SALJ* 284-305 and Osode P C "The new South African Insider Trading Act: Sound law reform or legislative overkill?" (2002) 45 *Journal of African Law* 239 248.

2 Jooste R "A Critique of the Insider Trading Provisions of the 2004 Securities Services Act" (2006) 123 *SALJ* 437.

3 *Ibid.*

8.2. RECOMMENDATIONS.

A number of recommendations aimed at resolving the insider trading problem are made with suggestions explaining how these recommendations can be best utilized to curb insider trading and related prohibited practices.

(i) *The researcher recommends establishment of separate and specialist courts for insider trading manned by experts in the relevant fields.*

The purpose is to address the concerns about the small number of cases that are successfully resolved.[4] Many cases have probably been abandoned due to the suspected incompetence of the officials of the courts on matters that relate to insider trading.[5] Delays and the everlasting backlog in the courts aggravates the situation.

The researcher therefore recommends the immediate establishment of specialist courts for insider trading cases on a regional basis or at least in each center where there is a division of the High Court of South Africa.

A judge who presides over insider trading cases may not always be a specialist in corporate law and securities trading. This may cause unnecessary delays, judgments that are open to criticism and if the prosecutors are not specialists, even withdrawal or abandonment of cases. It is therefore peremptory that these courts like in Canada and Australia[6] be administered by persons who have adequate and appropriate knowledge and expertise.

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4 See Crotty A "First Insider Trading Case goes to Court" *Business Report* 19 October 2001 *Sunday Times* 26 January 1997 25. Also see Osode P C "Defending the Regulation of Insider Trading on the Basis of Sound Legal Orthodoxy: The Fiduciary Obligations Theory" in Okpaluba C (ed) *Law in Contemporary South African Society* (2004) New Africa Books 303 and Jooste R *op cit* note 2 437.

5 See Chapters 3 and 4 of this dissertation.

6 See Chapters 6 and 7 of this dissertation respectively.

(ii) *The insider trading regulatory framework should not be rigidly based on the policy goal of deterrence alone.*

Although the policy goal of deterrence adopted by the legislature is very important, it should not be the only method of combating insider trading and related practices. Other policy goals such as detection and prevention of insider trading activity in securities markets and companies as well as other relevant institutions should be adopted as well. Severe penalties in the form of fines and long terms of imprisonment are necessary as is civil liability to compensate victims. This, however, has to be supported with proper preventative measures to discourage insider trading and related activities. Furthermore, regardless of how deterring penalties for insider trading might be, if insider trading activity is not detected in time and if action is not taken, some persons will always escape liability.

(iii) *The researcher recommends adequate awareness and education of insider trading offences to all relevant persons.*

Awareness and educational strategies are important to ensure that the public is aware of their rights and potential perpetrators of the effects of insider trading activity.

Apart from the insider trading manual (booklet) which was published by the Johannesburg Securities Exchange (JSE) at the request of the Minister of Finance, there are no other measures taken to make the public and the relevant shareholders or institutions aware of these matters.

Effective publicity campaigns even at grassroot level, and development of adequate curricula comprising securities trading for teaching at both secondary and tertiary levels in South Africa can be considered to be essential, for purposes of imparting knowledge about lawful and unlawful trading in securities.

(iv) *The legislature should consider adopting other non statutory measures such as incentives to encourage persons and institutions to disclose price-sensitive information relating to securities and to report incidences of insider trading timeously.*

In addition to adopting measures that are implemented in some highly respected jurisdictions such as Australia,[7] the legislature should consider to encourage every possible incentive such as whistle blowing without fear of reprisal.[8] Moreover, companies and relevant institutions should be encouraged to promote strong ethical compliance and a culture that encourages anti-insider trading practices such as whistle blowing. Furthermore, companies must be discouraged from ignoring whistle blowing or from dismissing employees who speak or reveal possible insider trading activities.

Companies and institutions must therefore be encouraged to develop adequate internal mechanisms to minimize insider trading. These will include arrangements like Chinese Walls and mandatory reporting obligations on the part of all their employees, to report any abuse of unpublished price-sensitive information relating to securities or other financial instruments. This may also encourage them to develop their own policies on timeous and accurate dissemination of information to the public.

(v) *The researcher recommends the enactment of adequate defences for insider trading.*

The New Act creates five offences that may be committed by an insider who knowingly abuses the unpublished price-sensitive inside information and fails to prove any of the proscribed defences on a balance of probabilities. The defences however, turned out to be inadequate[9] and are often difficult to prove on a balance of probabilities.

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7 See the analysis in Chapter 7 of this dissertation.

8 This is clearly reflected in the insider trading regulatory frameworks found in some respected jurisdictions notably, the United States of America and Canada. See Chapters 5 and 6 of this dissertation respectively.

9 See paragraph 4.6.3 in Chapter 4 of this dissertation for further analysis.

This created the risk of the provisions of the Act being perceived as draconian and of over criminalization of the insider trading offence, to cover innocent remarks or disclosure of price-sensitive inside information without the intention for such information to be acted upon by others.

The researcher recommends the addition of a Chinese Wall defence to protect bigger companies or institutions that developed and have successfully maintained measures to restrict the flow of information between departments.[10]

The researcher also recommends enactment of defences for persons who are *coerced* or *forced* to trade in any listed securities, for instance where directors for the purpose of not drawing the attention to themselves, force employees to buy or sell securities to avoid the risk of them being dismissed. Where this results in insider trading, a defence should be made available to the employees.

Lastly, like the Canadian and Australian experiences, the legislature should consider enacting specific exceptions to supplement the proscribed defences, to avoid accused persons from being liable unjustifiably.

(vi) *The researcher recommends different penalties for insiders (individuals) and institutions (juristic persons) and for the various offences.*

This entails different penalties firstly, for insiders who violate insider trading provisions for their own benefit or for the benefit of others and secondly, for tippees and thirdly, for persons who discourage or encourage others to deal in securities or who disclose price-sensitive inside information to others. Lastly, there must be a distinction between the penalties imputed on individuals (natural persons) and those imputed on companies or institutions (juristic persons). The maximum fine for a company should be substantially

[10] As is the position in Australia - see paragraph 7.2.6 in Chapter 7.

increased[11] and conviction of the company or juristic person should not exclude prosecution of its directors, managers or employees who were involved.

(vii) *The researcher strongly recommends the adoption of mandatory disclosure (duty to disclose) requirements for companies and all issuers of securities in the New Act.*

The New Act like its predecessor (the 1998 Act), did not provide for mandatory duties of disclosure of inside information for companies and issuers of securities. Unlike in other developed countries such as Australia,[12] the South African legislature seems to have ignored the importance of prompt disclosure of inside information. As stated by Jooste,[13] a mandatory duty on the part of companies and issuers to disclose their transactions relating to listed securities has meaningful advantages.

Firstly, it reduces the opportunities for insider trading activities.[14] Secondly, it gives all persons equal opportunities to trade on the basis of disclosed price-sensitive information (the equal access to information benefit). Thirdly, it will ensure that the South African insider trading legislation is internationally comparable to that of countries like Canada[15] and Australia.[16] Fourthly, as argued by Jooste, "a mandatory disclosure requirement increases the pool of information on which market analysts can draw in updating their

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11 See Jooste R *op cit* note 2 453.

12 For a detailed discussion, see Chapter 7 of this dissertation.

13 See Jooste *op cit* note 2 452.

14 See Osode P C *op cit* note 1 256.

15 In the Canadian legislation, the term "timely disclosure" is often used to constitute a mandatory obligation for companies and other issuers of securities to disclose their price-sensitive information relating to securities within the stipulated or reasonable time.

16 In the Australian regulatory framework, the term "generally available" is used with regard to a mandatory duty of disclosure requirement, imposed on companies and other issuers of securities to disclose their price-sensitive information within the stipulated or reasonable time.

assessments and forecasts of corporate performance thus enhancing the efficiency of the market".[17]

Disclosure requirements similar to those in the JSE disclosure requirements and SRP rules can be considered to be introduced to impose a duty on all companies or institutions to disclose without delay, any negotiations towards any transaction that is likely to have a material effect on the price of its securities or financial instruments. Public notice in a newspaper circulating in the Johannesburg area, newspapers circulating the area where the company or institution's registered office or principal place of business is situated, to Reuters, the South African Press Association and through the Stock Exchange News Service (SENS) may be advisable.

Although there was no room to discuss the JSE mandatory disclosure rules (which are internal rules of the JSE Ltd and not statutory principles) in detail in this dissertation, it must be noted that the Securities Services Act itself does not impose a duty of disclosure on the JSE, to report suspected insider trading activity, or unusual movements in the prices of securities, or unusual trade volumes. A statutory duty on the JSE to report these matters to the DMA may enhance co-operation between the JSE and the FSB.

It is generally agreed that the policy makers should provide for an adequate mandatory disclosure requirement coupled with appropriate criminal sanctions for companies or issuers who deliberately fail to comply with such a requirement.[18]

(viii) *The legislature should consider providing a direct right of action to issuers of securities as well as to aggrieved investors.*

The New Act does not clearly provide for a right of action to issuers of securities. Unlike the position in Australia, where offenders are liable to compensate the actual person

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[17] See Jooste R *op cit* note 2 453.

[18] See Osode P C *op cit* note 1 256.

affected by a particular insider trading transaction, such action is not clearly provided for in South Africa. The researcher also submits that affected issuers, in addition to lodging their claims with the FSB, should have the option to claim *directly* from convicted offenders if there is no surplus left in the account of the FSB or if no civil proceedings were instituted by the FSB and after having given notice to the FSB.

(ix) *Companies must have internal regulatory measures (mechanisms) that prohibit and discourage insider trading.*

If companies have in place adequate internal self-regulatory systems or mechanisms to combat insider trading, it may cause the financial markets and the securities industry to be more competitive in today's global economy which is characterized by vast technological advancement. The researcher recommends that for this reason and others that were stated previously, companies should be encouraged to have their own internal frameworks in place and they should be encouraged by the legislature to do so.

(x) *The legislature should consider engaging other regulatory bodies apart from the Financial Services Board (FSB) for the purpose of improving the effectiveness of the enforcement.*

Unlike in Australia, where the enforcement of the insider trading prohibition involves many regulatory bodies,[19] this is the responsibility, only of the FSB and its functionaries. Although the courts have a part to play in the enforcement of the insider trading ban, it is submitted that there appears to be too little co-operation and coordination between the FSB and the courts.[20] Other relevant regulatory bodies such as Bond Exchange of South Africa (BESA) should become more involved in complimenting the efforts of the FSB. This will help the public regulator (FSB) to raise adequate resources for effective enforcement of the insider trading prohibition.

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19 See paragraph 7.2.7 in Chapter 7 of this dissertation.

20 See paragraph 4.6.3 in Chapter 4 of this dissertation.

(xi) *Enactment and adoption of less stringent methods of prosecuting insider trading cases.*

The unsatisfactory state of affairs in relation to the number of prosecutions and of settlements[21] can largely be addressed by adoption of streamlined procedures for prosecution of the insider trading cases such as reducing the evidentiary burden of proof on the FSB and affected investors in civil cases. The researcher recommends further that the rebuttable presumption relating to the requirement of knowledge that was formulated in Chapter 4.2.2 be included in the New Act. It is hoped that this action will also help the Directorate for Market Abuse (DMA)[22] to secure more settlements.

Moreover, with respect to both criminal and civil cases, it is inherently difficult to establish whether the accused person knows that he has inside information since in many instances the facts (circumstances) to be established depend on the relevant court's discretion.[23] Henceforth, the researcher recommends that the courts should not be allowed to *rigidly* rely on the *requirement of knowledge* alone in order to impute liability on any accused persons. Instead, courts should be empowered to adopt a flexible approach that incorporates other less stringent methods such as exceptions or rebuttable presumptions as discussed herein.

(xii) *The legislature should consider adopting a more restricted and practically enforceable approach to combat insider trading.*

Unlike the position in Canada[24] and Australia,[25] the insider trading prohibition enjoys unlimited extra-territorial application in terms of the South African legislation but is

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21 See authorities quoted in note 4.

22 The functions of the DMA are well elaborated in Chapter 4 of this dissertation.

23 See Jooste R *op cit* note 2 442.

24 Refer to Chapter 6 of this dissertation for more explanatory and detailed study.

25 See paragraph 7.2.2 in Chapter 7 for further analysis and more elaborate discussion.

ineffectively enforced because of limited financial resources. A more restricted and practically enforceable approach having a territorial basis is recommended.[26]

(xiii) *The government and all relevant stakeholders should be fully involved and be supportive in relation to the regulation and enforcement of the insider trading prohibition.*

Only the FSB is directly involved in the enforcement of the insider trading ban. Apart from more involvement of other relevant regulatory bodies such as BESA and specialized units that investigate economic offences, the researcher recommends that government should put in place additional specialized units to prosecute insider trading and be directly involved in the actual enforcement in the courts of the provisions relating to civil liability. The FSB could then be left with the responsibility to monitor market tendencies that may point towards insider trading activity and engage other bodies to investigate, prosecute and litigate. The FSB, with the assistance of the DMA and the EC, should concentrate on the initial monitoring function, out of court settlements where justified and administration of claims by the aggrieved investors.

(xiv) *The policy makers should consider developing an adequate and effective corporate ethics culture that will be observed in companies and financial markets of South Africa.*

This relates to market professionals, such as brokers, financial analysts, lawyers, accountants and also publishing and printing companies in South Africa. It would be misleading to argue that these persons have nothing to do with the regulation of insider trading. These role players often have access to unpublished price-sensitive information in the course of executing their duties and ample opportunity to engage in insider trading activities. Administrative sanctions such as forfeiture of licences, suspension from profession or disqualification to serve as directors should also in this context, be

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[26] See Jooste R *op cit* note 2 453; paragraph 4.3.1 in Chapter 4.

considered by the legislature to promote such a strong corporate and professional ethics culture.

Furthermore, the researcher recommends effective programmes based on best organizational culture of companies and other institutions.[27] Such programmes could include developing effective anti-corruption measures and strategies, proper record keeping of compliance and adequate and effective auditing. The researcher recommends that the *company secretary* should be specifically responsible to the company for compliance with insider trading legislation and the internal regulatory framework of the company

(xv) *Introduction of an offence of attempted insider trading.*

Instances where an individual deliberately and intentionally discloses non public price-sensitive inside information to another person who somehow, does not trade or deal in relation to it is an offence. The same should be the case if any person attempts to purchase or sell or otherwise to benefit from unpublished inside information as such.

(xvi) *A complete repeal of the current provisions or alternatively an amendment thereof.*

The South African insider trading legislation is flawed and inadequate, both in its content and application[28] and insider trading is still a concern in regulated markets and listed companies as well as unregulated financial markets. The researcher therefore recommends a complete repeal of the current provisions or alternatively, a complete revision thereof so that they will be applicable to all financial markets, companies, other bodies and relevant persons.

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[27] See also Berenbeim R E "The Enron Ethics Breakdown" (Feb 2002) 15 *Executive Action* 5 http://www.conference-board.org 10 October 2006.

[28] This includes a substantial number of terms that are not adequately defined - see paragraph 7.2.1 in Chapter 7. Also see Jooste R *op cit* note 2 445.

8.3. CONCLUDING REMARKS.

There can be no doubt that the enactment of the New Act was a positive attempt by the legislature to improve the adequacy and enforcement of the insider trading provisions in South Africa. However, considering the many shortcomings of the New Act as outlined in this dissertation, it is clear that such an attempt was to a large extend unsuccessful.[29] It was pointed out in this research that many of the flaws found in the 1998 Act were repeated, sometimes even with the addition of the new ones. For this reason, it is recommended that the existing legislation be revised comprehensively with regard to the recommendations made in this research. It is hoped that this dissertation will make a *meaningful* contribution towards *combating* insider trading in South Africa.

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[29] Refer to Chapter 4 of this dissertation for more information.

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