

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

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

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

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

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

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.co.za> 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 report²⁶ 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 70nov (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

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 1973³³ 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.

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

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.

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

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 institutions⁴⁶ 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 listenership or during awkward hours, say very early in the morning or late at night.

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 Benningfield 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

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

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

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 Panel⁶⁴ and by notice in the *Government Gazette*, exempt any class of persons from the provisions of section 440F⁶⁵ 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:

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

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.

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

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

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 Africa⁸⁸ 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 21 October 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 markets⁸⁹ 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* (tippees 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

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 FSB⁹¹ 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 enforced⁹³ 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

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.