THE EFFECTIVENESS OF THE INSIDER TRADING REGULATION IN SOUTH AFRICA

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By:

Nothemba Lugaju

15280625

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Supervisor: Prof M.M. Botha

DECLARATION OF ORIGINALITY UNIVERSITY OF PRETORIA

Full names of student: Nothemba Lugaju

Student number: 15280625

Dissertation Title: The effectiveness of the Insider Trading Regulation in South Africa

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CHAPTER 1: INTRODUCTION TO THE STUDY

1.1 INTRODUCTION

The regulation of insider trading sparked different views regarding whether or not trading in price sensitive information by a person associated with the company by virtue of the position that he or she holds in that particular company, e.g. director, employee or shareholder; or by a person whom the inside information has been passed on by such director, employee or shareholder should be regulated. The first view supports fair trading, director's adherence with fiduciary duties and therefore favours regulating insider trading. The second view does not support the argument for criminalising insider trading based on, *inter alia*, that there is no victim and that the efficiency of the market is improved by insider trading.[1]

Both views are supported by strong and sensible arguments hence the need to investigate the necessity of regulating insider trading. The study seeks to uncover the concept of insider trading, the rationale for regulating insider trading and the effectiveness of the previous and current regulations.

1.2 THE RESEARCH PROBLEM

The research aims to investigate the causes for regulating insider trading, the common law position, the effect of having regulations in place and the effectiveness of these regulations.

1.2.1 The purpose of the study

The purpose of the study is to understand the historical position pertaining to dealing in inside information and to conduct a comparison with the current position with the aim of establishing the causes that led to the criminalisation of insider trading and the rationale for civil liability under Security Services Act. The outcome of the research will unearth whether regulating insider trading is necessary and if so, whether the current regulation is effective.

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[11] Cassim (ed.), *Contemporary Company Law* 2nd ed (2012) at 20-928-931.

1.2.2 The objectives of the study

The objectives of the study are as follows:

- To understand the concept of insider trading
- To establish the cause for criminalising insider trading and attracting civil liability to insider trading;
- To conduct a comparison between the common law position and the current position;
- To study the arguments supporting and criticising the legislation regulating insider trading;
- To establish if there is a conflict between insider trading and a director's fiduciary duty;
- To identify the strengths and weaknesses in the legislation regulating insider trading; and
- To conduct an analysis on whether the measures provided by the legislation are effective; and

1.2.3 The research questions

- What is Insider Trading?
- Is there a market for insider trading?
- What is the common law position regarding insider trading?
- What is the legal position pertaining to insider trading?
- Is there a conflict between insider trading and a director's fiduciary duty?
- What are the different views regarding the regulation of insider trading?
- Why is insider trading regulated?
- Is the legislation regulating insider trading effective?

1.3 LITERATURE REVIEW

The law regulating insider trading aims to regulate trading in inside information which is price sensitive by an insider and the person whom the insider information has

been passed on to (tippee / secondary insider).[2] There are different views pertaining to criminalising and legalising insider trading.[3] Some of the arguments supporting the criminalising of insider trading are based on the following views:

The first view asserts that trading in inside information breaches the fiduciary duty that the insider has towards the company and therefore attracts criminal liability since the company would have been wronged by such an action.[4] There is also a view that insider trading deprives investors of a fair and equal opportunity to participate in the securities market.[5] It is further argued that insider trading weakens the investors' confidence in the share market, given the unfairness of insider trading practice.[6]

The arguments supporting the legalising of insider trading are based on the views that, no one is harmed by insider trading and that insider trading improves the efficiency of the market thereby best serving the interests of the investors and the economy as a whole.[7]

The common law position makes it a breach of a director's fiduciary duty to trade on inside information thereby attracting liability by the director to the company for any profit made even if the company did not suffer any loss.[8] The basis for liability is

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[2] Lulz, "Prohibition against trading on insider information: the saga continues", (1990) 2 *South African Mercantile Law Journal* 328 at 330.

[3] Blackman et al., *Commentary on the Companies Act* (2002) Vol. 1 (Revision service 8, 2011) at 5-376; Cassim (ed.), *Contemporary Company Law* 2nd ed (2012) at 20-928.

[4] Blackman et al., *Commentary on the Companies Act* (2002) Vol. 1 (Revision service 8, 2011) at 5-376-1.

[5] *SEC v Texas Gulf Sulphur Co* (401 F.2d 833 (1968) 851-2).

[6] *SEC v Texas Gulf Sulphur Co* 401 F.2d 833 (1968) 851-2, cert denied 394 US 97 (1969).

[7] Manne, *Insider Trading and the Stock Market* (1966); Painter, *The Federal Securities Code and Corporate Disclosure* (1979); French & Rider "Should insider trading be regulated? Some initial considerations", (1978) 95 *South African Law Journal* 79; Hetherington, "Insider trading and the logic of law", (1967) *Wisconsin Law Review* 720 ; Schotland, "Unsafe at any price: a reply to Manne, insider trading and the stock market", (1967) 53 *Virginia Law Review* 1425.

[8] *Diamond v Oreamuno* 24 NY 2d 494 (1969).

owed to fact that the directors owe a fiduciary duty to their shareholders.[9] The 1973 Act prohibits a director from dealing in listed securities.[10] The Securities Services Act 36 of 2004 seeks to curb the insider trading practice and derives its motivation from the government's desire to create an environment which is conducive to foreign investment.[11] In achieving its objective the Securities Act and Financial Markets Act criminalises dealing in inside information by an insider and a secondary insider.[12] Stiff sanctions are imposed where an insider is convicted for dealing in inside information.[13] Certain acts relating to dealing in inside information may attract civil liability as well.[14]

The effectiveness of aforementioned regulations is questionable taking into account the defences available which an insider can raise in order to escape liability, and the burden placed on the prosecuting authorities to prove that the insider knew that he/she has insider information at the time that he/she traded in insider information.[15] Upon analysis of all available resources, the writer will evaluate the effectiveness of the regulations regulating insider trading and provide concluding remarks in this regard.

1.4 THE PROPOSED METHODOLOGY

The research will explain the concept of insider trading, provide a discussion on the historical and current position regarding insider trading, assess the necessity of regulating insider trading in view of its impact to the director's fiduciary duties, and evaluate the effectiveness the insider trading regulation. The chapters will be structures as follows:

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[9] *Percival v Wright* (1902) 2 Ch 421 (ChD).

[10] Section 224 of the Companies Act 61 of 1973.

[11] King Task Group, *Final Report* (n 63).

[12] Section 78 of the Financial Markets Act 19 of 2012; section 73(1)(a) of the Security Services Act 36 of 2004.

[13] Section 82 of the Financial Markets Act 19 of 2012.

[14] Section 77 of the Security Services Act 19 of 2012.

[15] Section 31(1)(b) of the Security Services Act 36 of 2004; section 78(1)(a).

- Chapter 2 will explain the concept of Insider Trading. The subheading thereunder will deal more specifically with the regulation of insider trading, the role players in insider trading and whether there is a victim in insider trading or not.

- Chapter 3 will conduct a comparison between the common-law position and the current position. The subheadings thereunder will deal with whether or not insider trading is criminalised under common, as well as the causes that led to the criminalisation of insider trading under the current Legislation.

- Chapter 4 will provide a discussion on the different views pertaining to insider training. The subheadings thereunder will deal with director's fiduciary duty, arguments in favour of insider trading and arguments criticising insider trading.

- Chapter 5 will discuss case law and enforcement proceedings as a means to deter insider trading.

- Chapter 6 will conduct an assessment of the overall research and provide concluding remarks on the effectiveness of the insider trading regulation in South Africa.

1.4.1 Research design

The methodology will rely on qualitative approach in that, an in depth study of literature and available sources will be conducted in order to understand the effectiveness of the current regulation regulating insider trading in South Africa. Bar graphs will be used to demonstrate examples and or scenarios.

1.4.2 Data sources

During the research the following sources will be utilised: documentary sources including legislation, case law, articles, journals, academic literature. Secondary sources will include personal observation and opinions.

1.4.3 Data collection techniques

Case law and articles data will be collected from the internet. Textbooks, Journals and Law Reports and Legislation data will be obtained from the Libraries.

1.4.4 Ethical considerations

The relevant sources will be acknowledged by making proper references in respect of data acquired from different resources.

CHAPTER 2: THE CONCEPT OF INSIDER TRADING

2.1 INTRODUCTION

The concept behind regulating Insider Trading was to prohibit individuals who have inside information relating to securities or financial instruments from dealing in such securities or financial instruments. In achieving the aforesaid objective, measures were required to be put in place in order to deter would be transgressors and to ensure compliance with the regulations. In this regard the regulation attracts civil and criminal liability to insider trading contraventions. Furthermore, the regulation vests powers such as investigation powers, adjudication powers and penalty collection powers (in respect of sanctions imposed) upon the Financial Services Board in order to give effect to the regulation's intended objective.[16]

Various academics in different eras have given their views regarding the definition of insider trading and the reasons compelling the regulation of insider trading.

According to Painter, Insider Trading arises wherever persons, including corporations, having fiduciary responsibilities, purchase or sell shares and the transactions are wholly or in part motivated by "inside" information acquired in the performance of their functions as fiduciaries. The more knowledgeable a man he becomes, the greater his advantage over the others. This was based on this logic that a person in public office is subject to severe criticism if he uses information acquired in the performance of his duties to speculate on the stock market. Also corporate officials, although not having public responsibilities in the same sense as those politically elected analogously to be taking fair advantage if they used inside information to their own advantage. This was a grey area, perhaps governed by a "double standard". On the one hand it was common knowledge that such practices were talked about as somehow wrongful or immoral. On the other hand it was common knowledge that people frequently succumb to the temptation of insider

[16] Preamble of Insider Trading Act 135 of 1998.

trading and that, for some, it was literally a way of life. The question therefore was, is dealing in inside information wrongful and unlawful?

If an affirmative answer was provided to the aforesaid question, it then gave birth to a host of other questions, for example:

(a) What types of insider trading which were in fact unlawful and what were the repercussions where the law had been contravened?
(b) Could such contravention attract civil or criminal liability which may lead to prosecution?
(c) Could one be liable to more than one person?
(d) Were corporations liable when they purchased or sold their own shares?
(e) If Mr X, an officer of company A, learnt that his corporation was about to sign a contract which favoured company B, could he purchase shares of company B?
(f) Could Mr X sell short if the contract negotiations fell through?
(g) Could Mr X purchase shares in the competitor before the news became public if Mr X learnt of the success of the competitor's bid on a government contract?
(h) Could Mr X profit from the inside information undisclosed to the general public with whom they dealt?
(i) Could a broker solicit a customer's account with the promise that, since his partner was a director of a particular company, he would have first-hand knowledge of the inside information and would let the customer "in" before the news breaks?[17]

In many prospects the insider trading problem was but one aspect of a broader area, namely, the balance which should prevail between the interest of those who invest and those who manage. The latter, in the course of performing their duties, would inevitably acquire information which could be used to a great advantage for private gain. Such information would at times be considered one of the privileges of corporate office, a privilege which was that of the management by right. The investor, on the other hand, at least theoretically, had furnished the capital. At any

[17] Painter, *The Federal Securities Code and Corporate Disclosure* (1979) at 3.01:60-61.

rate he had purchased shares in the company, purporting to give him an ownership interest. As a proprietor he could view the “inside” information as his or as belonging to the company rather than to a person he hired to manage his property and paid an adequate salary for doing so. It must however be realised that the realities of corporate life render those concepts of the relationship between the “investor” and his steward inappropriate, perhaps strangely so. An investor, by purchasing a share in the corporation, was allowed involvement in the corporation’s residual profits, an amount determined by the exercising of the management’s discretion in deciding what was necessary for the needs of the corporation. The question was, should the investor be content with this or should the investor be also entitled to all information about his company relevant for making informed investment decisions? Furthermore, should the investor, particularly, be entitled to assume that management, favoured by the advantage of being on the “inside”, would not use “inside information” to purchase or sell shares of the company, thus gaining profits which were not available to him as an ordinary investor? The balance between those conflicting roles, attitudes, interests, and “investor” and “manager”; gambler and corporate official with public responsibilities, could never be struck with any degree of accuracy. For, as “new occasions taught new duties”, it differed with the corporation involved and changed as society also changed and as our concept of the corporation changed. However, there were broad outlines of interests which could and should be legally protected.[18]

According to Cassim the use of the term ‘insider trading’ is misleading these days as it is used to refer to the sale and purchase of a company’s securities by persons associated with the company, known as ‘insiders’, who are in possession of “price – sensitive” information not generally available and gained as a result of that association. The law in this regard used to be an aspect of the law that governed the conduct of directors and officers of companies. Today, however, the law regulates all trading on “insider information”, not only by insiders, but also by persons to whom inside information has been passed on to by insiders (referred to as secondary

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[18] Painter, *The Federal Securities Code and Corporate Disclosure* (1979) at 3.01:61-63.

insiders or tippees), and persons who have otherwise wrongfully gained possession of such information.[19]

2.2 THE ROLE PLAYERS IN INSIDER TRADING

In order to define the role players who deal in inside information, it is necessary to first establish the meaning of inside information.

The term 'Inside information' refers to specific or precise information which has not been made public and which is:

(a) Obtained and learned as an insider; and
(b) If it were to be made public, would likely to have a material effect on the price or value of the shares listed on a regulated market.[20]

An insider, key role player in the offence of insider trading, is therefore defined as a person who has information:

(i) Through being a director, employee or shareholder of a share issuer listed on a regulated market to which the inside information relates; or through having access to such information by virtue of employment, office or profession; or
(ii) Where such person knows that the direct or indirect source of information was a person referred to in paragraph "i" above.[21]

2.3 INSIDER TRADING REGULATION

The United States was the first country to make a serious attempt to stamp out insider trading. The abuses which took place in share dealing in the stock market boom during the 1920's, led, after the market's slump in 1929, to a call for a reform. As a result the Securities Act of 1933 and the Securities Exchange Act of 1934 were

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[19] Cassim (ed.), *Contemporary Company Law* 2nd ed (2012) at 928.

[20] Section 72 of the Securities Services Act 36 of 2004; section 77 of the Financial Markets Act No. 19 of 2012.

[21] Section 72 of the Securities Services Act 36 of 2004; section 77 of the Financial Markets Act No. 19 of 2012.

enacted by Congress, the latter with the stated purpose of protecting 'the ordinary purchaser or seller of securities and to maintain fair and honest markets'.[22]

Section 16 of the Securities Exchange Act 1934 is specifically directed at deterring insider trading. Section 16(b) in particular seeks to deter 'short-swing' speculation by insider with advance information by rendering them liable to account to the company for any profit realised from any profit and sale, or sale and purchase, within a period of less than six months. If the company does not sue for the profit, any security holder may bring an action in the company's name. There is no requirement that the plaintiff show any use of inside information. Recovery is automatic and there is therefore really nothing to litigate. Although this provision has not been adopted in many other countries it has proved to be most effective.[23]

Rule10b-5, developed by the courts, provides a remedy to a person who has suffered prejudice as a result of insider trading. The aforesaid remedy involves two important steps, Firstly: Rule 10b-5 does not in any way refer to insiders, a total stranger in an arms-length transaction violates the Rule if he affirmatively misstates a material fact. However, by equating the insider's silence with the outsider's falsity, the federal courts developed the rule so as to govern insider trading. Secondly: Although the rule does not expressly grant a private remedy (it is silent regarding shareholder action), the courts have nevertheless accepted the existence of such right.[24]

Under the United States law, there are two basic theories under which trading on inside information becomes unlawful, both of which were created by the court under section 10(b) of the Securities Exchange Act 1934 and Rule 10b-5. These are discussed in paragraph 2.3.1, 2.3.2 and 2.3.3 below.

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[22] Blackman et al., *Commentary on the Companies Act* (2002-2005) Vol. 1 & 2 at 5-394.

[23] Loss, "The fiduciary concepts as applied to trading by corporate 'insiders' in the United States", (1970) 34 *Modern Law Review* 37.

[24] *Kardon v National Gypsum Co* 73 Supp 798 (1947).

2.3.1 The disclosure-or-abstain rule

The prohibition against insider trading began to take form in SEC v Texas Gulf Sulphur Co,[25] wherein Texas Gulf Sulphur Co subscribed to a policy of equality of access to information. The aforesaid policy was based on the Rule that anyone who possessed information was required to disclose it before trading or refrain from trading in the affected company's shares. The Federal Court of Appeal in SEC v Texas Gulf Sulphur Co ruled that this Rule also extends to a person possessing information who may not necessarily be termed an insider.[26]

The equal access policy was however rejected by the United States Supreme Court in *Chiarella v United States*,[27] and *Dirks v SEC*.[28] The court held that liability could be imposed if the defendant had a duty to disclose prior to trading. Therefore a duty to disclose arose where an insider trader breached a pre-existing fiduciary duty owed to the person with whom the insider trader traded.

2.3.2 Rule 14e-3

Rule 14 regulates insider trading on non-public information regarding tender offers. The Rule prohibits an insider of the bidder and target from disclosing information about a tender offer to persons who are likely to violate the rule by trading on the basis of that information. The Rule also prohibits any person who possesses material information relating to a tender offer by another person from trading in target company shares if the bidder has commenced or has taken steps towards commencement of the bid. The Rule is triggered if the person making an offer has taken steps towards making an offer. Furthermore the Rule is only limited to

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[25] 401 F.2d 833 (1968) 851-2, cert denied 394 US 97 (1969).

[26] 401 F.2d 833 (1968) 851-2.

[27] 445 U.S. 222 (1980).

[28] *Dirks v SEC* 463 US 646 653-655 (1983).

information relating to a tender. Therefore other types of insider trading are subject to the *Chiarella* judgment.[29]

2.3.3 Misappropriation

Misrepresentation theory is based on the notion that as an employee with access to tender documentation, although the aforesaid employee may not owe any duty to the investors with whom the employee traded, the employee owed a duty of confidentiality to his employer and thereby to the bidders. In this regard, Chiarella's misappropriation of material non-public information that had been entrusted to his employer was a sufficient breach of duty to justify imposing Rule 10-5 liability.[30] In *Us v Newman*, the misappropriation theory was adopted.[31] The misappropriation theory requires breach of fiduciary duty before trading on inside information becomes unlawful.

In England, the Cohen Committee in 1945 held a perception that it would be unreasonable to prohibit directors from dealing in shares of their company merely by reason that they would have more information in relation the company than the other party.[32] In 1952, South Africa's Millin Commission supported the views of the Cohen Committee and introduced the aforesaid views in the Companies Act 46 of 1926.[33] In England, the Jenkins Committee in 1962 expressed concerns regarding the position of the victim of the insider trading, thus recommending that a director who is guilty of insider trading should be liable to compensate a person who suffers as a result of such trading. This recommendation was however not implemented. The aforesaid Committee was also of the view that a director should be prohibited from dealing in options in the shares of his company, thus rendering unlawful this form of insider speculation. This recommendation was implemented. Therefore in England, until the passing of the Companies Act of 1980, the only sanctions imposed against insiders

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[29] Blackman et al., *Commentary on the Companies Act* (2002-2005) Vol. 1 & 2 at 5-394-4.

[30] *Chiarella v United States* 445 U.S. 222 (1980).

[31] *Us v Newman* 664 F.2d (1981).

[32] *Report of the Committee on Company Law Amendment* Cmd 6659 of 1945 at para 86.

[33] *Report of the Committee on Company Law Amendment* Cmd 6659 of 1945 at paras 86-87.

dealing in securities were only those exercised by the Stock Exchange and the Panel under the City Code on Take Over and Mergers.[34]

In South Africa, new provisions were introduced in the Companies Act 61 of 1973 based on the recommendation made by the van Wyk de Vries Commission. The Commission was of the view that the company suffers no harm as a result of insider trading, and therefore if some of control was to be introduced it should not be done on the area of relationship between the director and his company.[35] On the other hand, the sellers and purchasers of shares might suffer prejudice. Since the directors do not owe fiduciary duties to shareholders, the insider does not owe a fiduciary duty of disclosure to a seller of shares alike. The aforesaid Commission pointed out that with listed shares the parties to the transaction are anonymous thus leaving the victims of insider trading with no civil remedy available. The Commission therefore concluded that dealing in listed shares by an insider should be made an offence carrying a substantial penalty.[36] The Committee decided to entrust the courts with responsibility to develop laws regulating unlisted shares. The Committee also considered imposing a prohibition on directors from trading in options to buy or sell shares in their company or subsidiary. The recommendations of the Committee were adopted by the Legislature but for one exception:

Section 233 of 1973 Act made insider dealing in all shares an offence.[37]

In the UK, insider trading was first regulated by the provisions of the Companies Act of 1980. When the Companies Act of 1985 was passed, the insider trading provisions were moved to the Company Securities (Insider Dealing) Act of 1985 which criminalised insider dealing on a stock exchange and off market deals on listed shares.[38] In 1993 the Company Securities Act of 1985 was replaced with Part

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[34] *Millin Commission Report* (*Report of the Commission of Enquiry on the Amendment of the Companies Act* (UG 69 of 1948)) at para 141.

[35] Commission of Enquiry into the Companies Act *Main Report* (RP 45/1970).

[36] *Pretorius v Natal Sea Investment Trust* 1965 3 SA 410 (W) 417.

[37] Rider & French, *The Regulation of Insider Trading* (1979) at 396-399.

[38] Rider, "The crime of insider trading", 1978 *Journal of Business Law* 19.

V (ss 52-64) of the Criminal Justice Act of 1993 which only imposed criminal sanctions in respect of a dealing made in a regulated market.[39] Private transactions like the ones dealt with in *Percival v Wright* were therefore not affected. Furthermore only individuals with inside information could be held liable. Corporate bodies or juristic persons were therefore excluded.

In South Africa, the provisions in the 1973 Act proved to be ineffective. In 1989, the Securities Regulation Panel was established and vested with powers to make rules to regulate and investigate cases of insider trading. The provisions prohibiting insider trading were repealed as well as the provision dealing in options by directors. Section 440F substituted the new prohibition and the penalties were increased.[40] In 1990, subsequent to the new prohibition having received a great deal of criticism, a new section 440F was enacted.[41] Any person who knowingly dealt in securities on the basis of inside information was guilty of an offence.[42] Section 440F was silent on whether a transaction in contravention of s440F was void or voidable. It therefore proved to be ineffective and inadequate, in that no successful prosecution resulted. In September 1995, a committee was established to investigate insider trading in all financial markets and exchanges in South Africa. A King Task Group Draft Report was published in March 1997, followed by Final Report relating to Insider Trading Legislation, in October 1997. The King Task Group recommended that the Financial Services Board should administer the insider trading legislation. In January 1999, new provisions regulating insider trading were introduced by the Insider Trading Act 135 of 1998. Section 17 repealed section 440F of the Companies Act. Section 11 replaced the Securities Regulation Panel with the Financial Services Board as the insider trading watchdog.[43]

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[39] Alcock, "Insider dealing – how did we get here?", (1994) 15 *Company Lawyer* 67.

[40] Sections 229-233 of the Companies Amendment Act 78 of 1989.

[41] The Companies Second Amendment Act 69 of 1990.

[42] Section 441(1)(a) of the Companies Second Amendment Act 69 of 1990.

[43] Blackman et al., *Commentary on the Companies Act* (2002-2005) Vol. 1 & 2 at 5-394-9 & 10.

The Insider Trading Act was motivated by South Africa's reintegration into the international financial markets and the Government's aspiration to create an environment which encourages foreign investment[44]. The Insider Trading Act was defective in a number of respects and was repealed by the Securities Act 36 of 2004. The provisions of insider trading in the Securities Act[45] still remained defective and new deficiencies have been created.

The Securities Act 36 of 2004 was repealed by the Financial Markets Act[46] which came into operation on 03 June 2013. The Financial Markets Act provide for, *inter alia*, the regulation of financial markets; licensing and regulation of exchanges, regulation and control of securities trading, the custody and administration of securities; the prohibition of insider trading and other market abuses; the provision of codes of conduct; the replacement of the Securities Services Act, 2004 as amended by the Financial Services Laws General Amendment Act, 2008, so as to align this Act with international standards; and to provide for matters connected therewith. Section 78 makes it an offence to deal directly or indirectly for one's own account in the securities listed on a regulated market to which the inside information relates or which is likely to be affected by it. Section 82 prescribes penalties to be imposed to sanction non-compliances.

2.4 CONCLUSION

As to whether the new regulation is effective in eliminating or addressing the challenges that are inherent with insider trading is an issue that will be revealed in the final chapter. The next few chapters will provide a holistic assessment of the insider trading regulation and further provide an evaluation on the effectiveness thereof.

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[44] French & BAK Rider "Should insider trading be regulated? Some initial considerations", (1978) 95 *South African Law Journal* 79.

[45] Chapter Viii of Act 36 of 2004.

[46] Act 19 of 2012.

CHAPTER 3: COMPARISON BETWEEN COMMON LAW AND STATUTORY LAW

3.1 INTRODUCTION

It is imperative that in order to grasp the background to the insider trading regulation that a study of comparing the common law and statutory law position be undertaken. The results thereof will provide a much clearer picture of why this form of market abuse is regulated. Furthermore one will develop a better understanding of the shortcomings that came with each of the insider trading legislations, the reasons that led to other legislations having to be enacted and whether these legislations effectively addressed all the regulatory shortcomings.

3.2 COMMON LAW

Prior to 1973 Insider trading in South Africa was not prohibited by any legislation.

As a result thereof Insider trading was becoming rife and prevalent within the marketing space. The lack of insider trading legislation and enforcement discouraged foreign and local investment since confidence in SA financial markets was very low. The Commission of inquiry was therefore instituted to investigate regulation of insider trading.

3.3 COMPANIES ACT 61 OF 1973

For the first time in South Africa section 233 of the Companies Act, 1973 prohibited insider trading thus making it an offence to commit insider trading.[47] With time it became evident that there were major challenges in the application of the new insider trading regulation (s233) in that:

- The scope of the s233 prohibition was only limited to insider trading by primary insiders;
- "Price sensitive information" was not defined;
- The new regulation was only applicable to listed securities;

[47] Section 233 of the Companies Act 61 of 1973.

- The regulation only extended to securities covered by the Act;
- There were no mandatory disclosure requirements;
- Insider trading only attracted criminal liability thus making the burden of proof very high;
- The insider trading scope was very limited.48

Because s233 proved to be ineffective in arresting the rampant insider trading, it was repealed and replaced with section 440F which increased the penalties.[49] A new section 440F was enacted subsequent to the new prohibition having received vast criticism.[50]

Section 440F provided as follows:

> "Any person who, whether directly or indirectly, knowingly deals in a security on the basis of unpublished price-sensitive information, shall be guilty of an offence if the information has been obtained by virtue of a relationship of trust or other contractual relationship or through espionage, theft, bribery, fraud, misrepresentation or other wrongful method, irrespective of the nature thereof."

Section 440F broadened the scope of insider trading and addressed a majority of the shortcomings of s233. The Securities Regulation Panel was appointed to police insider trading. However whilst s440F was an improvement from s233, it still remained insufficient or inadequate in that it was silent on whether a transaction in contravention of s440F was void or voidable, resulting in unsuccessful prosecutions. The means of curbing and combating insider trading remained insufficient and or inadequate. Taking the aforesaid shortcomings into account, it became imperative to enact legislation specific to insider trading to fully tackle insider trading and address all shortcomings related thereto.

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[48] Mngomezulu, "The journey from insider trading to market abuse – have we succeeded it curbing the scourge?", presented 13 September 2011, available from https://www.chartsec.co.za/documents/2011SpeakerPresentations/TheRegulationOfInsiderTrading.pdf (accessed 22 November 2018).

[49] The Companies Amendment Act 78 of 1989.

[50] The Companies Second Amendment Act 69 of 1990.

3.4 INSIDER TRADING ACT 135 OF 1998

The Insider Trading Act[51] came into operation in 1999 and repealed the inadequate provisions of the Companies Act of 1973, in so far as insider trading is concerned[52]. The purpose thereof was to broaden the scope of the prohibition of insider trading. As already alluded to in chapter one, the Insider Trading Act introduced measures to curb insider trading activities such as:

- Civil and criminal liability for insider trading contraventions;
- Vesting the FSB[53] with powers to investigate, adjudicate over insider trading contraventions, imposition of administrative fines and collection administrative fines[54].

The Insider Trading Act[55] also established the Insider Trading Directorate whose function was to exercise the power of the Financial Services Board to institute any civil proceedings as contemplated in this Act in the name of the Financial Services Board.[56]

An insider was defined as an "individual" who has inside information

(a) through:
 (i) being a director, employee or shareholder of an issuer of securities or financial instruments to which the inside information relates; or
 (ii) having access to such information by virtue of his or her employment, office or profession; or

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[51] Act 135 of 1998.

[52] In terms of section 17 of Act 135 of 1998, "Section 440F of the Companies Act, 1973, is hereby repealed".

[53] Financial Services Board.

[54] Section 11 of Act 135 of 1998.

[55] Act 135 of 1998.

[56] Section 12 of Act 135 of 1998.

(b) where such individual knows that the direct or indirect source of the information was a person contemplated in paragraph (a)(ii).[57]

Two types of insiders were therefore envisioned under the Insider Trading Act. On the one hand, there were insiders who can be termed "primary insiders", namely, directors, employees or shareholders of an issuer of securities to which the inside information relates, and which may include insiders or individuals who, by chance as a result of their employment, had access to the inside information, but who were not necessarily the employees of the company itself. On the other hand, there were secondary insiders, also termed "tippees", being individuals who knew their source of inside information whether direct or otherwise was a primary insider.[58] Defining an insider as an "individual" created a gap where an offence of insider trading was committed by a juristic person, trust or any entity. Furthermore the term individual was not defined.

The scope was therefore too limited. This meant that officials/individuals could involve themselves in insider trading through their companies without the companies incurring any liability.[59] The exclusion could therefore be regarded as a serious flaw in law.

In relation to offences created by the legislation, the scope was only limited to:

(a) individual who knows that he or she has inside information and who-
    (i) deals directly or indirectly, for his or her own account or for any other person, in the securities or financial instruments to which such information relates or which are likely to be affected by it; or

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[57] Section 1 of Act 135 of 1998.

[58] Chitimira, "A historical overview of the regulation of market abuse in South Africa", (2014) 17 *Potchefstroom Electronic Law Journal* 937 at 956.

[59] Chitimira, "A historical overview of the regulation of market abuse in South Africa", (2014) 17 *Potchefstroom Electronic Law Journal* 937 at 956.

(b) encourages or causes another person to deal or discourages or stops another person from dealing in the securities or financial instruments to which such information relates or which are likely to be affected by it,

(c) Any individual who knows that he or she has inside information and who discloses that information to another person.[60]

From the above it is clear that for an individual to be charged with a criminal offence of Insider Trading, it was required that the individual must have had knowledge that he/she was in possession of inside information. This implied that the prosecuting authorities were vested with a burden of proving that the accused was aware that he/she was in possession of inside information. Without this evidence the prosecuting authorities would experience difficulty in proving the guilt of the accused individual beyond a reasonable doubt. Knowledge was therefore a pre-requirement for criminal liability and a stumbling block for prosecuting authorities.

The Financial Services Board, Courts, Insider Trading Directorate and the Directorate of Public Prosecutions were entrusted with the responsibility to jointly enforce sanctions applicable to Insider Trading violations. It was the function of the Financial Services Board to monitor and enforce the insider trading prohibition as per the powers vested upon it.[61] The Insider Trading Directorate was in turn responsible for exercising all the powers of the Financial Services Board.[62] It also had powers to either institute civil action or criminal action for Insider Trading violations. The Insider Trading Directorate also had the right to withdraw, abandon or compromise any civil proceedings in terms of the Insider Trading Act.[63] The capacity of the Insider Trading Directorate was however limited since it was highly dependent on the Johannesburg Stock Exchange Limited's[64] Surveillance Department for the detection of insider trading contraventions.

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[60] Section 2 of Act 135 of 1998.

[61] Sections 11(1) and (2)(a) to (i) and subsections (3)-(11) of Act 135 of 1998.

[62] Section 12 of Act 135 of 1998.

[63] Sections 6, 12(13) and (14) of Act 135 of 1998.

[64] Hereinafter referred to as the JSE.

According to Chitimira, even though the Insider Trading Act was enacted it failed to provide adequate definitions for some important insider trading terms such as "material effect", "insider trading", "inside information", "specific" or "precise" and "publication" and this omission contributed to the inconsistent enforcement of its provisions. Evidently, this omission was not addressed in the Securities Services Act, the Draft Financial Markets Bill, the Financial Markets Bill, 2012 and the Financial Markets Act. The Financial Markets Act will be discussed at length in paragraph 2.5 below.

Chitimira recommends that the drafters of the legislation should consider enacting adequate definitions to address market abuse practices in the South African financial markets. She further allude that despite the fact that the Financial Services Board was empowered to regulate insider trading, the prosecuting function was only vested mainly in the Directorate of Public Prosecutions. The same position was retained in the Securities Services Act, the Draft Financial Markets Bill, the Financial Markets Bill, 2012 and the Financial Markets Act.[65] This is bizarre taking into account that other regulatory bodies such as the National Home Builders Registration Council,[66] which regulates the home building industry, has jurisdiction to adjudicate over contraventions of its enabling legislation, the Housing Consumers Protection Measures Act.[67] This recommendation would enhance the criminal prosecution of market abuse cases in South Africa.

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[65] Chitimira, "A historical overview of the regulation of market abuse in South Africa", (2014) 17 *Potchefstroom Electronic Law Journal* 937 at 956.

[66] Established in terms of section 2 of the Housing Consumers Protection Measures Act, 95 of 1998, as amended.

[67] Act 95 of 1998, as amended.

3.5 SECURITY SERVICES ACT 36 OF 2004

The Securities Services Act[68] ("the SSA") repealed the Insider Trading Act. The SSA introduced a consolidated market abuse regime for SA and outlined four offences constituting market abuse, namely:

- Insider trading
- The publication of inside information
- Engaging in a prohibited trading practice
- Misleading or deceptive statements, promises or forecasts

Section 72 of the SSA defines an "insider" as a "person who has inside information through being a director, employee or a shareholder of an issuer of securities listed on a regulated market to which the inside information relates; or having access to such information by virtue of the position he/she holds; or where such person knows that the source of such information is an insider."

Section 73(1) of the SSA states as follows:

(a) An insider who knows that he or she has inside information and who deals directly or indirectly or through an agent for his or her own account in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it commits an offence.

(b) An insider is, despite paragraph (a), not guilty of any offence contemplated in that paragraph if such insider proves on a balance of probabilities that he or she-

 (i) was acting in pursuit of the completion of an affected transaction as defined in section 440A of the Companies Act;

 (ii) only became an insider after he or she had given the instruction to deal to an authorised user and the instruction was not changed in any manner after he or she became an insider.

Section 73(2)(a) of the SSA states as follows:

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[68] Act 36 of 2004.

- An 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 the inside information relates or which are likely to be affected by it commits an offence.

Section 73(2)(b) provides defences that may be raised by an insider in order to escape liability. In this regard, despite the provisions of section 73(2)(a), an insider who is able to prove on a balance of probabilities that he or she:

(i) is an authorised user and was acting on specific instructions from a client, save where the inside information was disclosed to him or her by that client;
(ii) was acting on behalf of a public sector body in pursuit of monetary policy, policies in respect of exchange rates, the management of public debt or external exchange reserves; or
(iii) was acting in pursuit of the completion of an affected transaction as defined in section 440A of the Companies Act;
(iv) only became an insider after he or she had given the instruction to deal to an authorised user and the instruction was not changed in any manner after he or she became an insider,[69]

may escape liability and accordingly may be found not guilty by the court of law. An additional defence is provided in section 73(3)(b) of the SSA.

Section 73(3) of the SSA states that:

(a) An insider who knows that he or she has inside information and who discloses the inside information to another person commits an offence.
(b) An insider is, despite paragraph (a), not guilty of the offence contemplated in that paragraph if such insider proves on a balance of probabilities that he or she disclosed the inside information because it was necessary to do so for the purpose of the proper performance of the functions of his or her employment, office or profession in circumstances unrelated to dealing in any security listed

[69] Section 73(2)(b) of the Securities Services Act 36 of 2004.

on a regulated market and that he or she at the same time disclosed that the information was inside information.

Section 73(4) of the SSA states that:

> An insider 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 the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it commits an offence.

The Directorate of Market Abuse was established and penalties were increased. Regarding insider trading, for the most part, subject to a few minor amendments, the SSA reproduces the contents of the Insider Trading Act. However, one significant amendment made by the SSA is that it widens the scope of who constitutes an "insider". In terms of the Insider Trading Act an "insider" was defined as an individual who has inside information[70], but under the SSA, an insider is defined as a person who has inside information[71]. A "person" would include an individual as well as a juristic person. The SSA goes further in that it defines a "person" as including a partnership and any trust for the purposes of the Market Abuse prohibitions.[72]

The Insider Trading Directorate established by the Insider Trading Act continues to exist despite the repeal of the Insider Trading Act, and is now known as the Directorate of Market Abuse.[73]

The effectiveness of this regulation is questionable taking into account the defences an insider can raise and the burden placed on the prosecution to prove that the insider knew that he/she has insider information at the time that he/she traded in inside information. Despite the scope of the Insider Trading legislation having been

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[70] Section 1 of Act 135 of 1998.

[71] Section 72 of Act 36 of 2004.

[72] Du Plessis & Cassim, "The Security Services Act", 17 May 2005, available from https://www.bowmanslaw.com/insights/the-securities-services-act-rudolph-du-plessis-and-rehana-cassim/ (accessed 23 November 2018); Section 72 of Act 36 of 2004.

[73] Section 83 of Act 36 of 2004.

increased by this legislation, there are still gaps created. For example, the legislation is silent on instances where insider trading is committed by a person (agent) acting on the instructions of an insider. It appears that the legislation does not extend to cover such instances, thus rendering the policing of insider trading inadequate or ineffective.

3.6 FINANCIAL MARKETS ACT 19 OF 2012

This Act came into operation on 03 June 2013 and it repealed the SSA that governed the regulation and control of exchanges and securities trading. The Financial Markets Act[74] ("the FMA") seeks to align South African legislation with international standards. In relation to insider trading, the FMA has increased its scope by introducing section 78(3)(a) which states that:

(a) Any person who deals for an insider directly or indirectly or through an agent in the securities listed on a regulated market to which the inside information possessed by the insider relates or which are likely to be affected by it, who knew that such person is an insider, commits an offence.
(b) A person is, despite paragraph (a), not guilty of any offence contemplated in that paragraph if the person on whose behalf the dealing was done had any of the defences available to him or her as set out in subsection (2)(b)(ii) and (iii) of the aforesaid legislation.

Inside information is defined as specific or precise information, which has not been made public and which is obtained or learned as an insider; and 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.[75]

The scope of the Financial Markets Act[76] is however limited to only listed shares in a regulated market, thereby leaving a gap for unscrupulous persons to become

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[74] Act 19 of 2012.
[75] Section 77 of Act 19 of 2012.
[76] Act 19 of 2012.

involved in market abuse practices in unlisted securities. Furthermore the words precise and material are not defined resulting in interpretation of statutes having to be employed; and foreign legislation or sources having to be consulted in order to arrive at the meaning intended by the legislature. The current regulation is not self-sufficient in this regard and therefore creates challenges inherent with interpreting statutes, such as powers having to be given to higher courts to rule on the correct interpretation and setting precedence e.g. in the case of *Zietsman and Another v Directorate of Market Abuse and Another*.[77] This case and other relevant case law, pointing out this deficiency, will be dealt with in depth in Chapter four.

According to Chitimira,[78] it is clear that the various market abuse laws introduced in South Africa were aimed mainly at enhancing the insider trading regulation in order, amongst others, to restore public investor confidence in our financial markets. Several amendments to the market abuse legislation were introduced from time to time with the view to effectively curb market abuse practices in South Africa. However, it has been shown that the Financial Markets Control Act had little success in combating market manipulation in South Africa. For example, there is no statutory authority conferring jurisdiction upon the Johannesburg Stock Exchange to prosecute and preside over market manipulation cases in South Africa prior to 2004. To date, despite various amendments made to legislation and new legislation passed into law this defect remains unresolved even in the Financial Markets Act. In the light of this Chitimira[79] recommends that the drafters of the legislation should consider introducing a specific provision into the current market abuse legislation that gives powers upon the JSE's Surveillance Division to prosecute or report incidents of market abuse to the Financial Services Board. One would however disagree with Chitimira’s notion in this regard considering that the FSB is the

[77] *Zietsman and Another v Directorate of Market Abuse and Another* 2016 (1) SA 218 (GP) (24 August 2015).

[78] Chitimira, “A historical overview of the regulation of market abuse in South Africa”, (2014) 17 *Potchefstroom Electronic Law Journal* 937.

[79] Chitimira, “A historical overview of the regulation of market abuse in South Africa”, (2014) 17 *Potchefstroom Electronic Law Journal* 937.

Regulatory body and as such, such powers should be conferred upon it instead of the JSE. Such powers would defeat the FSB's reason for existence. This function would therefore fall outside the scope of the JSE especially when considering its mandate.

Chitimira[80] alludes that it has been noted that the Stock Exchanges Control Act and the Financial Markets Control Act did not expressly provide for other anti-market abuse methods such as arbitration and alternative dispute resolution, whistle-blowing and bounty rewards. Furthermore, provisions in the Companies Act (including all its amendments) were not only inconsistent for the purposes of curbing insider trading, but were also not adequately enforced. She further alludes that the anti-market abuse enforcement methods adopted under the Companies Act as amended were insufficient and only confined to criminal sanctions only. Other methods such as whistle-blowing and bounty rewards were not considered. This shortcoming was retained in the Securities Services Act, the Draft Financial Markets Bill, the Financial Markets Bill, 2012 and the Financial Markets Act. Chitimira[81] recommends that the legislation drafters should consider legislating additional provisions for anti-market abuse measures such as whistle-blowing and bounty rewards into the current market abuse legislation to enhance the combating of market abuse in South Africa.

3.7 CONCLUSION

The absence of insider trading legislation and enforcement under common law discouraged foreign and local investment. It was therefore paramount that legislation be introduced to regulate market abuse practices. The legislations that were initially enacted to curb insider trading proved to be inadequate in doing so as already highlighted in the paragraphs above. The scope of the Insider Trading Act was too narrow under the Insider Trading Act resulting in gaps being created in the legislation, thus rendering the policing of insider trading inadequate/ineffective. The

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[80] Chitimira, "A historical overview of the regulation of market abuse in South Africa", (2014) 17 *Potchefstroom Electronic Law Journal* 937.

[81] Chitimira, "A historical overview of the regulation of market abuse in South Africa", (2014) 17 *Potchefstroom Electronic Law Journal* 937.

issue of insufficient definitions in the SSA and omission of important definitions in the FMA remains a challenge and a limiting factor in the adequate enforcement of the insider trading regulation. In the next chapter the focus shifts to the director's fiduciary duties as well as the opposing views pertaining to the criminalisation of insider trading.

CHAPTER 4: DIFFERENT VIEWS RELATING TO INSIDER TRADING

4.1 INTRODUCTION

The law regulating insider trading aims at regulating trading on inside information which is price sensitive by an insider and the person whom the insider information has been passed on to (tippee / secondary insider).[82] There are different views pertaining to whether insider trading should be criminalised or not.[83] The arguments supporting the criminalisation and the non-criminalisation of insider trading are based on the views that are expressed hereunder.

4.2 THE DIRECTOR'S FIDUCIARY DUTIES

A director has a duty of fairness and good faith towards the organisation[84] and in dealing with shareholders, because of the legal privileges that directors enjoy in having both access to and responsibility for corporate information inherent with their positions. The shareholders on the other hand are disadvantaged in that they do not possess a similar privilege.

This position has been retained in the King IV code which provides that directors owe their duties to the company. Since a company is represented by several interests which include shareholders, employees, consumers and the environment, directors are required to act in good faith in the interest of the company with these represented interests blended therein.[85] Dealing in inside information would clearly be in contrast with the director's duties and would constitute a breach of a director's fiduciary duty, the King IV Report on Corporate Governance™ for South Africa 2016

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[82] Lulz, "Prohibition against trading on insider information: the saga continues", (1990) 2 *South African Mercantile Law Journal* 328 at 330.

[83] Blackman et al., *Commentary on the Companies Act* (2002) Vol. 1 (Revision service 8, 2011) at 5-376.

[84] Section 76 of the Companies Act 71 of 2008

[85] King IV Report on Corporate Governance™ for South Africa 2016; Esser & Delport "Shareholder protection philosophy in terms of the Companies Act 71 of 2008", (2016) 79 *Journal of Contemporary Roman-Dutch Law* 1.

and the Financial Markets Act 19 of 2012. According to Principle 11 of the King IV Report, the governing body should govern risk in a way that supports the organisation in setting and achieving its strategic objectives. In this regard, in relation to risk the following must be disclosed:

(a) An overview of the arrangements for governing and managing risk;
(b) Key areas of focus during the reporting period, including objectives, the key risks that the organisation faces (insider trading should be one of the potential risks an organisation may be exposed to), as well as undue, unexpected or unusual risks and risks taken outside of risk tolerance levels; and
(c) Actions taken to monitor the effectiveness of risk management and how the outcomes were addressed.[86]

Principle 13 requires companies to adhere to statutory obligation, disclose measures to mitigate non-compliance and disclose repeat non-compliances and sanctions imposed.[87] This implies that where a director was sanctioned for violations of insider trading, the organisation is required to disclose such.

In respect of Directors of companies, adopting good corporate governance practice is crucial more so if they intend to rely on the protection afforded by the business judgement rule as provided in the Companies Act, in a pending litigation. Where there are no sound governance structures and processes, it will be difficult for a director to show that reasonable steps were taken to become informed, that there was no material financial gain; and there was a valid ground for the director to believe that a decision was in the best interest of the company.[88]

4.2.1 Arguments in favour of criminalisation of insider trading

The argument supporting the criminalisation of insider trading is fundamentally based on the notion that insider trading impairs the ethical and fairness principles

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[86] General Guidance Note, Summary of King IV™ Disclosure Requirements © IoDSA.

[87] General Guidance Note, Summary of King IV™ Disclosure Requirements © IoDSA.

[88] King IV Report on Corporate Governance™ for South Africa 2016.

inherent to trading. Furthermore legalising insider trading would give way for a director to trade in inside information without incurring liability for breach of his/her fiduciary duties. Various sources provide various well-substantiated views calling for the criminalisation of insider trading.

Blackman asserts that trading in inside information breaches the fiduciary duty that the insider has towards the company and therefore attracts criminal liability since the company would have been aggrieved by such conduct.[89]

Another view is that insider trading deprives investors of a fair and equal opportunity to participate in the securities market.[90]

There is an argument that insider trading weakens the investors' confidence in the share market, given the unfairness of insider trading practice.[91]

Manne provides the so-called "adverse selection" argument to this discussion. The argument is that since stock exchange specialists (or other market makers) systematically lose money as a result of insider trading, they will increase their bid-ask spread in order to cover this greater cost of doing business. By so doing, it is argued that they pass along the cost of insiders' trading to all outside investors with whom they deal, commonly known as the "insider trading tax".[92] The crux of this argument is that short-term traders would repeatedly lose to insiders. According to Manne the disadvantages of insider trading are, *inter alia*, as follows:

- Valuable information lands in the hands of individuals inside and outside the company who should not be compensated, because they did nothing to produce the valuable new information.

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[89] Blackman et al., *Commentary on the Companies Act* (2002) Vol. 1 (Revision service 8, 2011) at 5-376-1.

[90] *SEC v Texas Gulf Sulphur Co* (401 F.2d 833 (1968) 851-2).

[91] *SEC v Texas Gulf Sulphur Co* 401 F.2d 833 (1968) 851-2, cert denied 394 US 97 (1969)

[92] Manne, "Insider trading: Hayek, virtual markets, and the dog that did not bark", (2005) 31 *Journal of Corporation Law* 167 at 2.

- The value of the information cannot be measured to the value of the contribution of a particular individual. The value of new information will, in many cases, be a function of the financial ability of someone to trade on the information or of their ability to evaluate new knowledge.
- Insider trading as compensation cannot be measured in advance as part of a compensation plan.93

Rider's views are as follows:

For fairness, there should be an equalisation of the position of persons who deal with the insider himself. It is unfair that an insider who has an advantage over an outsider uses this advantage to cause the outsider loss or the deprivation of a gain. The detriment to the outsider, *in casu*, is the unfair advantage that the insider has over the outsider. The unfairness in this regard is not attributable to any industry or merit that might otherwise justify the result and make the trading fair, thus it is unjustified. To support this argument, Rider refers to a New Zealand decision of Mahon J, where the learned judge imposed a duty of fairness and good faith on directors dealing with shareholders, because of the legal privileges that directors enjoy in having both access to and responsibility for corporate information inherent with their positions. Rider argues further that shareholders are disadvantaged in that they do not have a similar right of access to the information.[94]

4.2.2 Arguments against criminalisation of insider trading

The argument supporting the legalisation of insider trading is fundamentally based on the notion that no one is harmed by insider trading furthermore that insider trading improves the efficiency of the market thereby best serving the interests of the investors and the economy as a whole. Various sources provide various well-substantiated views on why insider trading should be legalised.

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[93] Manne, "Insider trading: Hayek, virtual markets, and the dog that did not bark", (2005) 31 *Journal of Corporation Law* 167 at 4.

[94] French & Rider "Should insider trading be regulated? Some initial considerations", (1978) 95 *South African Law Journal* 79 at 80-82.

Manne outline the benefits from the practice of insider trading as follows:

- Insider trading can be used as an important component of executive compensation.95
- The practice of insider trading does no significant harm to long-term investors.
- There are positive benefits from the practice one being, the compensation argument, and the other being that insider trading contributes importantly to the efficiency of stock market pricing.
- Employees would not suffer a predicament of being left with no money options.
- There would be no loss of reward when an innovation merely resulted in a reduction of an expected loss. There would be no unearned gain because a company's stock appreciates in line with a market or industry rise.
- There would be no disappointments about the number of shares optioned or granted to particular employees.
- There would be no renegotiations in relation to the option plan every time the stock takes a nose dive.
- There would be no peculiar problems of accounting, since there would be no reason to put the right of employees to trade on undisclosed information.96

The idea that there is no direct harm from the practice has held up very well, especially the point that no real damage is caused to an investor who engages anonymously on an exchange in a trade with an insider on the other side of the transaction. To counter act the argument of the short-term investor raised in paragraph 4.1.1 above, there is an argument that insider trading brings about less monetary concerns to a long-term investor, and the same thing remains true regardless of the existence of some adverse selection. Furthermore, there is also

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[95] Manne, "Insider trading: Hayek, virtual markets, and the dog that did not bark", (2005) 31 *Journal of Corporation Law* 167 at 2.

[96] Manne, "Insider trading: Hayek, virtual markets, and the dog that did not bark", (2005) 31 *Journal of Corporation Law* at 2-3.

evidence that the harm to market makers is only existent in theory than it does in the actual market environment.[97]

The argument for a strong positive relationship between market efficiency and insider trading has proved to be very robust. According to Harold Demsetz, access to inside information may allow controlling shareholders to be compensated for the additional risk they assumed by not being well diversified.[98]

The view expressed by the supporters of insider trading is that the practice of insider trading: enhances market efficiency; ensures prompt accurate pricing of securities thereby improving the economy's allocation of capital investment and reducing the instability of the share prices; is a justifiable and efficient method of rewarding the directors for having uncovered the inside information; and benefits the company and consequently the society because of the incentive it creates to be innovative.[99]

4.3 CONCLUSION

Having assessed both opposing views, one thing that remains prominent is the fiduciary duty that a director has towards the organisation in which he/she is employed, and the obligation to act in good faith inherent with that position as set in section 76 of the Companies Act.[100] Having said that, it therefore follows that it would be unethical for a director to disclose price-sensitive information, which is privileged, and such conduct would not only be unethical but would also constitute a breach of its fiduciary duties. The next chapter zooms into the adjudication of insider trading violations in quasi-judicial forums and in the high courts as an enforcement mechanism to curb of insider trading contraventions and the effectiveness of the aforesaid enforcement mechanisms.

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[97] Manne, "Insider trading: Hayek, virtual markets, and the dog that did not bark", (2005) 31 *Journal of Corporation Law* 167 at 2.

[98] Demsetz, "Corporate control, insider trading and rates of return", (1986) 76 *The American Economic Review* 313.

[99] *SEC v Texas Gulf Sulphur Co* 401 F.2d 833 (1968) 851-2, cert denied 394 US 97 (1969).

[100] Act 71 of 2008.

CHAPTER 5: MEASURES DETERRING INSIDER TRADING IN SOUTH AFRICA

5.1 INTRODUCTION

Now that one has a grasp of what constitutes insider trading, it follows that one would be curious to uncover whether do the authorities empowered with instituting action in instances where insider trading is detected; preside over insider trading contraventions; impose administrative penalties and or appropriate sentences or sanctions, perform their functions optimally with the available resources in the form of applicable legislation. This chapter will reveal the effectiveness of such regulations when practically applied in the appropriate forums.

5.2 THE REGULATORY INSTITUTIONS

5.2.1 The Financial Services Board

The Financial Services Board (FSB) is a statutory body that is responsible for investigating market abuse contraventions set out in the Financial Markets Act (FMA).[101] The FSB carries out the mandate of the Directorate of Market Abuse (DMA),[102] a committee appointed by the Minister of Finance, to investigate and enforce the market abuse contraventions. Insider trading in particular is regulated by section 78 of the FMA. Offences committed prior to 3 June 2013 are regulated by sections 73, 75 and 76 of the Securities Services Act[103] and offences committed post 03 June 2013, are regulated by sections 78, 80 and 81 of the FMA.[104] The FSB has jurisdiction to adjudicate insider trading contraventions; to enter into settlement agreements and to impose appropriate penalties guided by the penalty clause of the relevant legislations.[105]

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[101] Act 19 of 2012.

[102] Section 83 of the Securities Service Act 36 of 2004.

[103] Act 36 of 2004.

[104] Section 84(2)(a) of the Financial Markets Act 19 of 2012.

[105] Section 84 of the Financial Markets Act 19 of 2012.

The FSB protects the integrity of the South African financial markets, thereby protecting members of the public and investing community who trade in securities listed on a regulated market. Where a contravention of the FMA has been detected, the DMA may refer the matter to the FSB's Enforcement Committee for enforcement action to be instituted against the offender, refer the matter to the National Prosecuting Authority for criminal prosecution or apply for a court interdict or attachment order in relation to any matter referred to in Chapter X of the FMA.

For insider trading to be detected by the Johannesburg Stock Exchange, the JSE would list the requirements which all issuers or companies are required to comply with. Dissemination of information goes to the whole market at the same time. If it is good news the JSE would monitor people who purchased shares prior to the dissemination of the information. The JSE would thereafter meet with DMA to discuss the observations, where after the FSB may decide to conduct an investigation. Upon finalisation of the investigations, the FSB may:

- pursue action in terms of section 6 of the Financial Institutions Act 28 of 2001, as amended by section 42 and 43 of the Financial Services Laws General Amendment Act 2008 (Amendment Act of 2008); or alternatively
- refer the matter to the DMA committee.

If there is insufficient evidence linking the company to the contravention, the matter will be closed on that basis. However, if there is sufficient evidence, the matter may be referred to the National Prosecuting Authority or internally for the imposition of an administrative penalty.[106] In the event that the Enforcement Committee deals with a person and criminal sanctions are later instituted, the presiding judge would be required to take into account any administrative sanctions that might already have been imposed.[107] Therefore there is no double jeopardy. The FMA makes it an offence to commit insider trading and upon conviction the offender may be liable to pay a fine of R50million of be subjected to a term of imprisonment not exceeding five

[106] Section 84(10) read with section 82(1) of the Financial Markets Act 19 of 2012.

[107] Section 80(2) of the Security Services Act 36 of 2004.

years or both.[108] Historically preference has been to refer insider trading cases to be dealt with internally within the FSB due to lack of knowledge and experience by the NPA when it comes to these specialised cases.

The Enforcement Committee may, if it is satisfied that there was a contravention, impose the following sanctions:

- profit made;
- three times the value of profit;
- R1million; and
- legal costs and investigation costs.[109]

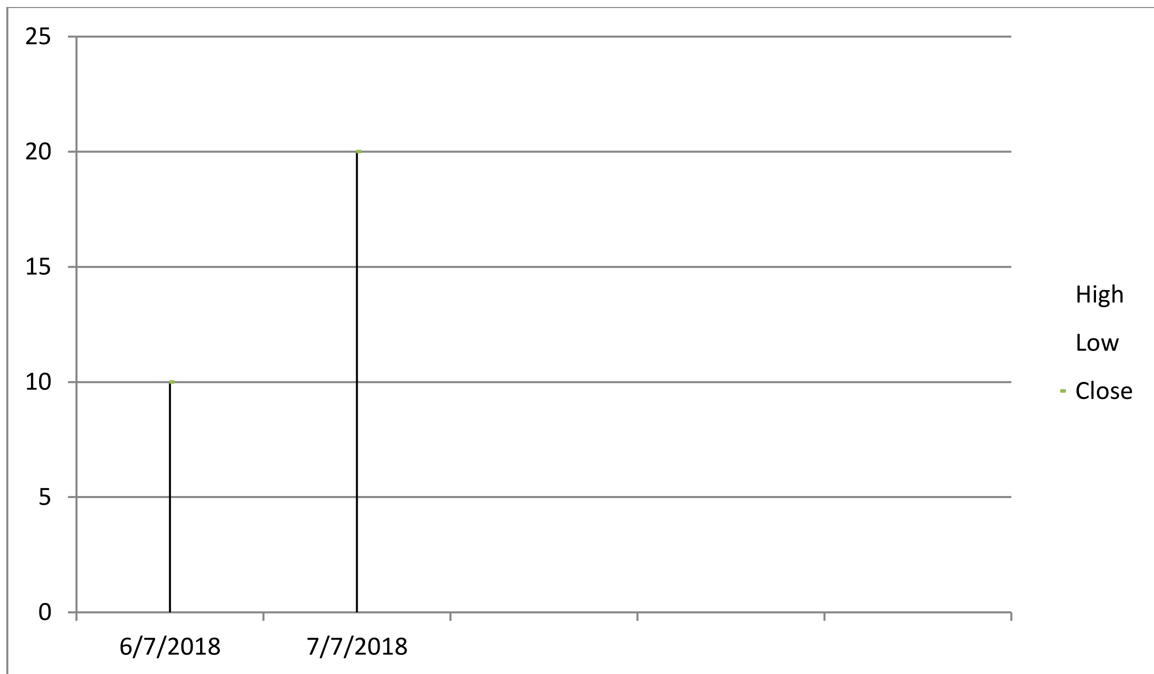
The standard of proof is on a balance of probabilities.[110]

A simplistic demonstration of the aforesaid sanctions would be in a scenario whereby director of company A obtains inside information on 06 July 2018 whilst the share price of the securities was trading at R10.00 per share. Director of company A purchases a single share on 06 July 2018. The good news information is disseminated to the market on 07 July 2018 and the share price is increased from R10.00 to R20.00 per share, as demonstrated in the below stock chart. The director of company A accordingly makes a profit of R10.00.

[108] Section 109 of the Financial Markets Act 19 of 2012.

[109] Section 82 of the Financial Markets Act 19 of 2012.

[110] Section 6D(a) of the Financial Institutions (Protection of Funds) Act 28 of 2001, as inserted by section 43 of the Financial Services Laws General Amendments Act 22 of 2008 and amended by section 167(a) of the Financial Services Laws General Amendments Act 45 of 2013.



From the above scenario the Enforcement Committee is empowered to impose a sanction upon director of company A as follows:

- an amount of R10.00 being the total profit made;
- an amount of R30.00 being 3 x the value of profit made;
- an amount of R1 million;
- interests; and
- legal costs (inclusive of investigation costs).

The victims of insider trading would be all the persons who would have traded, the details of which would be found on the broker dealer account system.

A determination of the Enforcement Committee pertaining to a sanction may be taken on appeal to the High Court (as was the case in *Pather*)[111] however such

[111] *Pather v FSB* [2014] 3 All SA 208 (GP).

application for appeal does not suspend the operation or execution of the Enforcement Committee's determination.[112]

Chitimira recommends that the FSB be financially and statutorily empowered to procure its own market abuse surveillance systems and transfer the entire financial markets anti-market abuse surveillance responsibility from the JSE to the Financial Services Board.[113] One tends to not agree entirely with this notion of transferring the entire financial markets anti-market abuse surveillance responsibility from the JSE to the regulatory body however one would recommend that the JSE surveillance responsibility be complemented by an internal FSCA surveillance system in order to widen the detection measures available so as to ensure efficiency and effectiveness in combating market abuse and more especially Insider Trading.

5.2.2 The Financial Services Conduct Authority

The Financial Services Board Act of 1990 has been repealed by the Financial Sector Regulation Act for 2017. Financial Services Board (FSB) has therefore been replaced by the Financial Services Conduct Authority (FSCA) which came into force on 1 April 2018 with the aim of creating a safer financial sector which protects consumers and reduces threats to the financial system, in line with the Financial Sector Regulation Act of 2017.

Some of the objectives of the FSCA are to provide support to the efficiency and integrity of financial markets, assist in maintaining financial stability and support financial inclusion and transformation of the financial sector.[114] The Financial Sector Tribunal has been established for those aggrieved by an FSCA decision.[115] This Tribunal replaces the former FSB Appeal Board. If a person feels by an

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[112] Section 6F(1) and (2) of Act 28 of 2001 as inserted by section 43 of Act 22 of 2008 and amended by section 169 of Act 45 of 2013 (supra).

[113] H Chitimira, "A historical overview of the regulation of market abuse in South Africa", (2014) 17 Potchefstroom Electronic Law Journal 965.

[114] Section 57 of the Financial Sector Regulation Act 9 of 2017.

[115] Section 219 of the Financial Sector Regulation Act 9 of 2017.

administrative decision (administrative penalty imposed by the FSCA), he or she may apply to the independent Financial Services Tribunal to have the decision reviewed or reconsidered. The Financial Sector Regulation Act gives the FSCA investigation powers,[116] powers to determine the need for enforcement action and powers to implement enforcement actions inclusive of administrative penalties. In respect of insider trading cases the FSCA may order that the alleged offender pay a profit of up to three times such amount. These funds are distributed after recovery of costs, to aggrieved persons aggrieved by the unlawful transactions.

Market abuse transgressions also constitute criminal offences in terms of the FMA.[117] The Director of Public Prosecutions may therefore institute criminal action against any offender as this is not the function of the FSCA. However, the FSCA would provide all information necessary to assist with criminal prosecutions.

Since 1999, the FSCA, and its predecessors, the Directorate of Market Abuse and the Insider Trading Directorate investigated a total of 413 cases. 295 cases were closed due to lack of evidence or insufficient evidence that the FMA (or the now repealed Insider Trading Act and Securities Services Act) was contravened. In 91 cases the FSCA/DMA decided to proceed with enforcement action. The penalties imposed on offenders to date amounts to approximately R108 million.[118]

5.3 CASELAW

5.3.1 *Pather v Financial Services Board*

In Pather's case,[119] the Enforcement Committee of the FSB had handed down its findings that Ahvest and Pather contravened section 76(1)(a) of the SSA.[120] On

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[116] Section 134 to 139 of the Financial Sector Regulation Act 9 of 2017.

[117] Financial Markets Act, No. 19 of 2012

[118] Financial Sector Conduct Authority, "Regulatory action forum", 26 July 2018, available from https://www.fsca.co.za/News%20Documents/FSCA%20Press%20Release%20-%20Regulatory%20Action%20Forum%20-%2026-07-2018.pdf (accessed 30 November 2018).

[119] *Pather and Another v FSB and Others* 2014 (9) BCLR 1082 GP.

[120] Act 36 of 2004.

review in the High Court the applicants contended that the findings of the Enforcement Committee and the sanction be set aside. They argued that to the extent that the statutory basis for investigations of which the Directorate was seized and which had not yet been referred to the Enforcement Committee remained unaffected by the 2008 Act as a matter of basic statutory interpretation and as such the transitional provisions of section 78(4) of the Amendment Act of 2008 cannot apply to such investigations. Furthermore that the transitional provisions can apply only to investigations which had already been referred to the Enforcement Committee and which, owing to the effect of the Amendment Act of 2008, rested on an uncertain foundation. The applicants questioned the jurisdiction of the Enforcement Committee to impose administrative sanctions in light of section 79(1).[121] The applicants pointed out contradictions in the legislation and argued that the transitional provisions provided for in section 78(4) of the Amendment Act of 2008 do not extend to the circumstances of their case in that, section 94(e) of the SSA empowered the DMA to refer a matter investigated by it to the Enforcement Committee, whilst section 83(1)(c) of the SSA provides that the Directorate exercises the powers of the Board to investigate any matter relating to an offence referred to in section 82(2)(a) of the SSA. Section 78(4) of the Amendment Act of 2008 on the other hand refers to investigations instituted by the Enforcement Committee. At the same time section 104[122] gives the Enforcement Committee powers to impose administrative sanctions contrary to the provisions of section 79(1).

All these contradictions render the legislation inadequate to such an extent that the interpretation of the legislation has to be sourced elsewhere, i.e. in the intention of the legislature and the Interpretation Act in order to establish the correct meaning of the Act. This uncertainty and/or inadequacy led to the findings of the Enforcement Committee being subjected to a review in the High Court. This was also partly due to

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[121] Section 79(1) of the Securities Services Act 36 of 2004: Only a High Court or a regional court has jurisdiction to try any offence referred to in section 73, 75 and 76 and to impose a penalty up to the maximum set out in section 115(a).

[122] Securities Services Act 36 of 2004.

the poor drafting of the legislation. The decision of the Enforcement Committee may have been confirmed by the High Court however subsequent to thorough research on to the background of Insider Trading and other market abuse, foreign law, reasons that led to the enactment of previous Insider Trading legislation as well as other legislations that led to the enactment of the SSA and the Amendment Act of 2008, and the comparison between SA and foreign law. As such the adequacy and effectiveness the South African Insider Trading regulation is questionable.

The appellants subsequently lodged an appeal at the Supreme Court of Appeal based on the following grounds:

- The incorrect civil standard of proof applied by EC to proceedings which are criminal in nature;
- That the court a quo erred in finding that the EC did have jurisdiction in the matter: and,
- The court a quo erred in not finding sections 102 to 105 of the Act unconstitutional.

After careful consideration of the ground for appeal, the court looked at the legislative scheme, foreign jurisprudence, and the nature of the proceedings and concluded that the proceedings before the EC could not be categorised as being criminal in nature, therefore the civil standard of proof applied. It also held that the penalties imposed by the EC are administrative in nature. After careful consideration of the Constitution and Canadian jurisprudence, the court found that the appellants were not "accused persons" and therefore do not fall within the ambit of section 35(3) of the Constitution;[123] and that criminal court jurisdiction and the administrative penalty jurisdiction awarded to the EC co-exist in terms of the legislative structure[124].

Once again the courts (SCA) had to rely on foreign law in order to confirm the decision of the EC.

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[123] Act 108 of 1996.

[124] *Pather v Financial Services Board* (866/2016) [2017] ZASCA 125 (28 September 2017).

5.3.2 *FSB v Coal of Africa and Mr Bronn*[125]

The facts of the case are as follows:

On the 13th of March 2015 Coal published an announcement on SENS on the progress that had been made to obtain Makhado mining rights. Based on that announcement, it seemed that the approval of Coal's application to obtain the mining rights was imminent. On the 15th of May the Department of Mineral Resources confirmed that the Makhado mining rights were granted to Coal. On the 15th of May 2015 the respondent was fully aware of the granting of the aforementioned mining rights before these details were released to the general public. The respondent was also aware that an announcement regarding the granting of the mining rights was to be published on SENS during the morning of the 18th of May 2015.

Due to the planned SENS announcement, the respondent was specifically instructed by the CEO only to buy Coal shares on the 18th of May, after the disclosure of the information to the market, pursuant to an enquiry addressed by the respondent himself to the CEO as to whether he could purchase Coal shares.

On the 15th of May 2015 at 13:44 the respondent bought 117 000 Coal shares, mostly at 84c per share and paid an amount of R98 262.00. When he traded, he was well aware that Coal had been granted the mining rights and that this information was unpublished.

In order for there to be a contravention of Section 78A, it is required that the insider must know that he had inside information and that the insider must know that he was dealing directly or indirectly with the relevant authorities. The parties attempted to reach an agreement about whether there had been a contravention of this section. In paragraph 1.2 of the respondent's Heads of Argument the respondent accepts that viewed objectively he contravened Section 78(i)(a) of the Financial Services Act. What it seems, is that the respondent is asserting, that he did not know subjectively that he had inside information or that he did not know he was dealing.

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[125] Enforcement Committee proceedings – ex temporae judgment – 28 February 2017.

On page 71 of the record, Mr Brown, the CEO of Coal, stated that Mr Bronn requested permission to buy Coal shares just prior to the 13th of May 2015. The permission was granted at the same time on condition that he purchased the shares after the release of the announcement concerning the granting of the mining rights on Monday the 18th of May.

Page 25 of the record makes it apparent that there was an urgency that the trade be done before the end of the day, being the 5 15th of May 2015. The record shows that the respondent, Mr Bronn, asked and, I quote “will you still be able to purchase some shares or assist me to do that before the end of the day?” This was a telephonic discussion that he had with a Mr Bell who was a dealer at Thebe. The dealing was done while the broker and the respondent were on the phone together and the broker stated, and I quote “okay sir, it is confirmed, you bought 117 000 Coal of Africa shares at 84c per share”, to which the respondent replied “alright, perfect”.

It was the applicant’s contention that the respondent knew that he had inside information and also knew that he had dealt in the securities before the release of the SENS announcement on the 18th of May 2015. It was thus the applicant’s view that there was a material dispute of fact between the applicant and the respondent; that is the respondent contends that only on an objective basis can it be said that he contravened the section in contrast to the applicant’s view that subjectively the respondent knew that he had inside information and that he knew that he dealt in the shares before the 18th of May 2015.

This was the reason for the applicant’s assertion that the matter had to be proceeded with on a contested basis.

The chief operations officer of Coal of Africa, Michiel Jakobus Bronn received an administrative penalty for insider trading following his action of having defied an instruction by the company’s chief executive officer not to trade in securities. The Enforcement Committee after thorough deliberations decided to fine Bronn an amount of R350 000.00.

Bronn was further ordered to pay the investigation costs of the case in addition to the imposed penalty.

Again, even after the amendment of the SSA, the authorities are still not relieved of the burden to prove that the insider knew that it was trading in inside information as evident in this case. It may be that that the judgment was not contended and subjected to a review and that there was sufficient evidence (though circumstantial) to prove knowledge, but what about instances whereby such evidence cannot be obtained? The reality is that such an insider will be get away scot free.

5.3.3 *Zietsman v Directorate of Market Abuse*

In Zietsman's case,[126] the appellants (Zietsman and Harrison & White Investments (Pty) Ltd), whom the FSB had found or made a determination that they had, when buying shares, been in possession of inside information that Africa Cellular Towers (a company that the appellants had intended to acquire a majority interest in) would be getting a R99 million loan from the Industrial Development Corporation (IDC), argued in the High Court that they did not know that the information in their disposal at the time of acquiring shares from ACT constituted inside information as per section 72 of the SSA. It appeared from the facts of the case that what was in dispute was whether the information the appellants relied upon to purchase the shares constituted inside information. The High Court had to decide whether such information constituted inside information as defined in the SSA or not. Due to the inadequacy of the South African legal sources, as conceded to by the respondents,[127] the High Court was obliged to, over and above having consulted the SSA and the Financial Markets Act,[128] consult foreign law as well in order to make a determination in this regard. It is important to point out at this stage that the SSA did not define "precise information". Therefore the true interpretation thereof needed to

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[126] *Zietsman and Another v Directorate of Market Abuse and Another* 2016 (1) SA 218 GP (24 August 2015).

[127] Directorate of Market Abuse and Financial Services Board.

[128] Act 19 of 2012.

be ascertained. However, it is also important to first understand the definition of an insider as set out in the SSA.

According to Jooste, the 'by virtue' or ‘through being’ requirement of the definition of 'insider'[129] creates potential difficulties. He outlines possible scenarios where one could possibly be an insider and escape liability merely because the legislation confines access to inside information to a person who acquires information through being a director or by virtue of employment. Where a barman at a golf club overhears inside information being discussed by a couple directors as he takes their order, is the barman excluded from the definition? Clearly, in this scenario, the prosecution does not need to establish a business or professional relationship between the individual (barman) and the company, as the 'access by virtue' category of insider in the Act makes no mention of an 'issuer of securities'.[130] Jooste is of the view that the intention of the legislature would be to include the barman as a secondary insider (‘tippee’) and the prosecution simply has to prove that the tippee knew he had received his information from an inside source. Be that as it may, it would still have to be proven that the information constitutes inside information and in this regard the interpretation of ‘inside information’ would have to be determined as was the case in *Zietsman*.

The charges against the appellants had been instituted under the provisions of the now repealed SSA. Insider trading is currently regulated by the FMA which came into operation on 3 June 2013.[131] The interpretation of “inside information” was found in the following foreign sources where a close link of the term “inside information” was established:

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[129] Section 72 of the Securities Services Act 36 of 2004.

[130] Jooste, “The regulation of insider trading in South Africa – another attempt”, (2000) 117 *South African Mercantile Law Journal* 284.

[131] Morajane, “What constitutes ‘inside information’ for purposes of insider trading? Zietsman v Directorate of Market Abuse 2016 1 SA 218 (GP)” (2017) *Journal of Contemporary Roman-Dutch Law* 506.

The EU Directive 2003/6[132] which provides that information:

> "[is to] be deemed to be of a precise nature if it indicates a set of circumstances which exists or may reasonably be expected to come into existence or an event which has occurred or may reasonably be expected to do so and if it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of financial instruments."

The EU Market Abuse Regime which regulates the misuse of non-public price sensitive information, which is of a "precise nature" holds the same view as the tribunal in *Massey v Financial Services Authori*ty[133] which provides that,

> "…to be 'precise' information must indicate that circumstances exist or that an event has occurred (or may reasonably be expected to come into existence or occur); and be specific enough to enable a conclusion to be drawn as to the 'possible effect' of those circumstances or that event on the price of the relevant investments."

In Ian Charles Hannam v The Financial Conduct Authority,[134] where the question was whether the two email sent by Mr Ian Charles Hannam to the Minister for Oil and to a potential investor contained inside information and therefore constituted market abuse, it was held by tribunal that Mr Hannam's actions were not in the proper course of the exercise of his employment, therefore Mr Hannam could not rely on the section 123[135] defences. It was held further that for information to meet the second part of the precise test, one would need to be able to draw a conclusion as to the possible direction of any movement.

This approach was rejected In the case of *Lafonta v AMF*,[136] where the EU Court of Justice held in as follows:

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[132] Article 1(1).

[133] UKUT 49 (TCC) ([2011] All ER (D) 95 (Feb)).

[134] [2014] UKUT 0233 (TCC).

[135] Financial Services and Markets Act 2000.

[136] Lafonta v AMF C-628/13 (36-37).

> "The increased complexity of the financial markets makes it particularly difficult to evaluate accurately the direction of a change in the price of particular instruments. If it were to be accepted that information is to be regarded as precise only if it makes it possible to anticipate the direction of a change in the prices of the instruments concerned, it would follow that the holder of the information could use uncertainty in that regard as a pretext for refraining from making certain information public and thus profit from that information to the detriment of the other actors on the market".

The tribunal further held that:

> "…on a proper construction of point (1) of Article 1 of Directive 2003/6 and Article 1(1) of Directive 2003/124, in order for information to be regarded as being of a precise nature for the purposes of those provisions, it need not be possible to infer from that information, with a sufficient degree of probability, that, once it is made public, its potential effect on the prices of the financial instruments concerned will be in a particular direction."[137]

In *casu* (*Zietsman*) the respondent submitted that, in the context of this matter, it is not only instructive but necessary to do a foreign law comparison on inside information. This on its own demonstrates the inadequacy of the insider regulation in South Africa. The High Court confirmed the decision of the Enforcement Committee however reliance was placed heavily on foreign law in arriving at a decision.

According to T Morajane this case set a precedent on the meaning of the type of information that is required for commission of the insider trading offence. Morajane outlines interesting requirements identified through the use of foreign law in the *Zietsman* case as discussed above, and is of the view that the presiding judge

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[137] *Ian Charles Hannam v The Financial Conduct Authority* [2014] UKUT 0233 (TCC).

correctly held that there was no basis for setting aside the Enforcement Committee's determination.[138]

5.4 CONCLUSION

On the issue of case law as a deterrent, a question that should also be asked is why is it that insider trading contraventions are not being referred to the Director of Public Prosecutions. The cases discussed above all emanate from the Enforcement Committee and not from the criminal courts. A penalty in the form of a fine surely cannot serve as a deterrent, more especially if the company is well established with a huge turnover or the director is wealthy. A criminal sentence, as opposed to an administrative penalty comes with a criminal record. Furthermore, in addition to an option of a fine, it further has an option of a jail term which is within the discretion of the presiding officer. The regulation is not being enforced to its full extent and is thus ineffective.

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[138] Morajane, "What constitutes 'inside information' for purposes of insider trading? Zietsman v Directorate of Market Abuse 2016 1 SA 218 (GP)" (2017) *Journal of Contemporary Roman-Dutch Law* 506.

CHAPTER 6: CONCLUDING REMARKS AND RECOMMENDATIONS: ASSESSMENT OF EFFECTIVENESS OF THE INSIDER TRADING REGULATION

In this dissertation a holistic assessment of the insider trading regulation was conducted and revealed as follows:

Chapter 1 and 2 is a demonstration that Insider trading has foreign roots. When Insider Trading was introduced to South Africa, heavy reliance was placed on foreign law because of its origins. Over the years South Africa started developing its own legislations however challenges emanated in the application thereof as certain gaps in the legislation were detected which disabled the authorities from adequately curbing the trade. These include among others omitted definitions, conflicting sections, etc. The question now is: does the FMA introduce provisions that address the omitted definitions in the SSA? Is the South African Insider Regulation self-sufficient?

As mentioned in Chapter 2, the current regulation is not self-sufficient as it creates challenges inherent with interpretation of the statute resulting in reliance having to be placed upon higher courts to rule on the correct interpretation and setting binding precedence e.g. in the case of *Zietsman*[139] which was thoroughly discussed in Chapter 4.

FMA introduces s78(3) which criminalises the conduct of an agent dealing in inside information on behalf of an insider. This appears to be the only addition to the regulatory provisions found in the SSA. The scope of the Financial Markets Act is also limited to only listed shares in a regulated market, thereby leaving a gap for unscrupulous persons to become involved in market abuse practices in unlisted securities without any consequences equivalent to sanctions applicable to listed shares. Furthermore the words precise and material are not defined resulting in interpretation of statutes having to be employed and other foreign legislation or

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[139] *Zietsman and Another v Directorate of Market Abuse and Another* 2016 (1) SA 218 (GP) (24 August 2015).

sources having to be consulted in order to arrive at the correct interpretation intended by the legislature.

Chapter 4 demonstrated different views pertaining to criminalisation of the practice of insider trading and legalisation thereof yielded conflicting results, some authors advocating for legalisation of the practice and some advocating for criminalisation of the practice. Having assessed both views one thing that remains prominent is the fiduciary duty that a director has towards the organisation in which he/she is employed and the obligation to act in good faith inherent with that position as set in section 76 of the Companies Act.[140] In light of this, it follows therefore that it would be unethical for a director to disclose price-sensitive information, which is privileged, and such conduct would constitute a breach of its fiduciary duties. In essence it would not be ideal for a director to commit insider trading as such conduct would have an effect of impairing his/her integrity and would also constitute a deviation from the director's fiduciary duties.

The discussion on case law and other insider trading measures in the previous chapter reveal a heavy reliance on foreign law in assisting the courts in making an informed decision in cases involving Insider Trading. Both applicants and respondents in their submissions to the courts would argue that, it is not only instructive but necessary to do a foreign law comparison on inside information. The courts accept this argument as evidenced in the decisions that they make in this regard.

Another point of concern which hinders the effectiveness of the Regulation is the absence of the provisions widening the scope of insider trading detections and the reporting thereof. Currently reliance is placed heavily on the JSE Surveillance Department on this regard. It appears that the FSB seems to be disempowered to conduct own monitoring and detection. This defect has not been cured by the Financial Sector Regulation Act 9 of 2017 which created the FSCA. This creates a risk of having incidences not being reported. This is a flaw overlooked during the

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[140] Act 71 of 2008.

drafting of the current laws and can be mitigated by introducing laws empowering the FSCA to conduct its own monitoring and detection in addition to the JSE Surveillance. The rationale behind this is that the FSCA is the Regulatory body which exists to ensure, *inter alia*, Insider Trading is curbed through enforcement of the Insider Trading Regulation by way of investigations being conducted, imposition of administrative sanctions where warranted, institution of civil actions and criminal actions against wrong doers. Therefore FSCA has a vested interest in ensuring that its existence is justified and that the legislation, rules and regulations governing it are effective.

The current legislation, as is, does not provide adequate measures to curb Insider Trading. Amendment of the laws, as discussed, would have to conducted, in consultation with all relevant stakeholders, to ensure that no stone is unturned in addressing the current weaknesses in the regulation thus ensuring the effectiveness of the regulation.

Another challenge hindering the effectiveness of the regulation is reliance on the National Prosecuting Authority's prosecutors to prosecute Insider Trading cases in respect of cases that have not been referred to the Enforcement Committee for administrative penalties to be imposed. The South African Police Services, whom criminal cases are reported to, and the National Prosecuting Authority, which is responsible for criminal prosecutions, are not familiar with the Financial Markets Act[141] as this is a recent statute. The said institutions are often overworked with serious and often violent offences therefore statutory insider trading offences are the least of their priorities. There are no specialised courts tasked with dealing with these matters. Neither does the FMA nor the Criminal Procedure Act[142] make provision for specialised courts to specifically deal with insider trading contraventions.

[141] Act 19 of 2012.

[142] Act 51 of 1977 as amended.

Recommendation

Having regards to the above challenges the following measures may introduced in order to address some of these:

The establishment of specialised courts in order to enhance the current prosecutorial enforcement mechanisms in place intended to curb insider trading. The advantages of establishing these courts are as follows:

- Ease the burden of dealing with unfamiliar cases in the regular courts;
- Provide faster services as it would specialise on only contraventions of the Financial Markets Act[143] and related legislations;
- Ensure successful prosecution by prosecutors who have specialist knowledge;
- Keep ordinary people (people accused of Insider Trading) separate from hardened criminals.

There are statutory bodies that prosecute own cases in criminal courts, such as the Municipality. Section 179 of the Constitution of the Republic of South Africa,[144] read with the National Prosecuting Authority,[145] as amended, provides for a single national prosecuting authority in the Republic South Africa. Section 112 of the Local Government: Municipal Systems Act[146] provides as follows:

> "With regards to prosecution of offences, a staff of a Municipality authorized in terms of section 22(8)(b) of the National Prosecuting Authority Act 1998[147] to conduct the prosecutions, may institute criminal proceedings and conduct the prosecutions in respect of a contravention of or failure with provisions of:
>
> - A by-law or regulation of the Municipality
> - Other legislation administered by the Municipality

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[143] Act 19 of 2012.

[144] Act 108 of 1996.

[145] Act 32 of 1998.

[146] Act 32 of 2000.

[147] Act 32 of 1998.

- Other legislation as the NDPP may determine in terms of section 22(8)(b) of the National Prosecuting Authority Act.[148]"

Similarly the Financial Markets Act[149] can be amended and provisions be inserted to allow appointment of specialist prosecutors by the FSCA and criminal prosecution powers in respect of market abuse cases be given to FSCA appointed prosecutors. The status quo of relying on the Directorate of Public Prosecution to institute criminal cases and for the FSCA only to provide information, as discussed in chapter 5, impairs on the effectiveness of the regulation due to the absence of specialised courts and specialist prosecutors.

The Financial Markets Act should be further amended by inserting the omitted definitions as already referred to in chapter 3 and 5 above.

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[148] Act 32 of 1998.

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