

Some Aspects of Insider Trading – Has the Securities Services Act 36 of 2004 Gone too Far?

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1 Introduction

The Securities Services Act 36 of 2004 (the ‘SSA’) came into effect on 1 February 2005. It repealed the Stock Exchanges Control Act 1 of 1985, the Financial Markets Control Act 55 of 1989, the Custody and Administration of Securities Act 85 of 1992, and the Insider Trading Act 135 of 1998 (the ‘ITA’) and consolidated them into one measure. However, it is more than a consolidation as the Act also amends the repealed laws in many important respects in order to correct and improve some of their provisions. In so doing it adds a significant number of new provisions to the previous measures.¹

Amongst other things, the object of the SSA is to enhance confidence in South African financial markets by contributing to the maintenance of a stable financial market environment and by promoting the international competitiveness of securities services² in South Africa.³ This article will examine the prohibition of insider trading, which is to be found in Chapter VIII of the SSA,⁴ a chapter that regulates the broader offence of market abuse.⁵ In particular, this article will compare the insider-trading prohibitions which existed in the repealed ITA with those of the SSA and will consider whether perplexities that had existed in the ITA have been rectified in the SSA.

It will be submitted that although the SSA is an improvement on the ITA, it has sadly failed to address some of the uncertainties of the ITA, and, to compound this failure, it has perhaps unwittingly introduced additional uncertainties into our law on insider trading. This article will conclude that, in its aim to increase confidence in the South African financial markets and to promote the international competitiveness of securities services in South Africa, the SSA has considerably tightened the regulation of insider trading in

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¹ See the Memorandum on the Objects of the Securities Services Bill, 2004, published as GN 1746 in GG 26684 of 18 Aug 2004.

² In terms of s 1, securities services are services provided in terms of the SSA in respect of –

- (a) the buying and selling of securities;
- (b) the custody and administration of securities;
- (c) the management of securities by an authorised user;
- (d) the clearing of transactions in listed securities; and
- (e) the settlement of transactions in listed securities.

³ See ss 2(a)(ii) and 2(d) of the SSA.

⁴ Specifically, in s 73 of the SSA.

⁵ In addition to the offence of insider trading, two other offences constitute market abuse, viz, engaging in a prohibited trading practice, and the making or publishing of false, misleading or deceptive statements, promises and forecasts.

South Africa, but may in so doing have gone too far in regulating the offence of insider trading. It will also be considered whether the regulation of insider trading in South Africa may be made more effective.

2 The Extension of the Insider Trading Legislation to ‘Persons’

The ITA had in s 1 defined an ‘insider’ as an ‘individual who has inside information’. The SSA now defines an ‘insider’ in s 72 as a ‘person who has inside information’.⁶ ‘Person’ is then defined to *include* a partnership and a trust.⁷ Section 2 of the Interpretation Act 33 of 1957 defines ‘person’ as including

- ‘(a) any divisional council, municipal council, village management board, or like authority;
- (b) any company incorporated or registered as such under any law; and
- (c) any body of persons corporate or unincorporate.’

It seems, therefore, that the SSA has indeed extended the scope of the insider-trading prohibition to include not only natural persons but also juristic persons, which would include companies incorporated outside of South Africa,⁸ as well as partnerships and trusts. Prior to the promulgation of the ITA, s 440F⁹ of the Companies Act 61 of 1973 had extended the application of the insider trading prohibition to any ‘person’, which meant that it applied to natural and juristic persons. The ITA subsequently restricted the application of the insider trading prohibition to individuals. No explanation for this limitation was provided in the Memorandum on the Objects of The Insider Trading Bill, 1998.¹⁰ But the Final Report by the King Task Group into Insider Trading Legislation (the ‘Final King Report’)¹¹ upon whose recommendations the ITA was largely based, recommended that liability for insider trading should be limited to individuals due to doubts concerning the effectiveness of Chinese Walls. The Final King Report stated as follows:

‘In view of the lack of development in our law of the jurisprudence concerning the efficacy of the Chinese Wall, the Task Group decided that both the criminal offence of insider trading and the civil remedy set out in the proposed legislation should be limited to conduct by an individual.’¹²

⁶ More fully, s 72 of the SSA defines an ‘insider’ as meaning ‘a person who has inside information – (a) through –
 (i) being a director, employee or shareholder of an issuer of securities listed on a regulated market to which the inside information relates; or
 (ii) having access to such information by virtue of employment, office or profession; or
 (b) where such person knows that the direct or indirect source of the information was a person contemplated in paragraph (a)’.

⁷ Section 72 of the SSA.

⁸ See part (b) of the definition of ‘person’ in s 2 of the Interpretation Act which defines ‘person’ as including any company incorporated or registered as such under ‘any law.’

⁹ Section 440F was repealed by s 17 of the ITA with effect from 17 Jan 1999.

¹⁰ B134-98.

¹¹ The King Task Group was requested to conduct an investigation into insider trading in South Africa and to make recommendations that would enhance public and international confidence in the South African statutory and regulatory measures to prevent insider trading practices. The Final King Report was published on 21 Oct 1997.

¹² The Final King Report in par 3.1.2.

In contrast, the English Criminal Justice Act, 1993 (the ‘CJA’),¹³ which regulates, inter alia, insider trading in that country,¹⁴ still applies to individuals and has not been extended to juristic persons. Gower and Davies expressed the view that the reason for excluding companies from the purview of the CJA was because of the difficulties that Chinese Walls gave rise to:

‘Corporate bodies were excluded, not because it was thought undesirable to make them criminally liable but because of the difficulties it was thought would be faced by investment banks when one department of the bank had unpublished price-sensitive information about the securities of a client company and other departments had successfully been kept in ignorance of that information by a “Chinese Wall” or otherwise. One of these other departments might deal in the shares, in which event the bank as a single corporate body would arguably have committed an offence had the Act applied to corporate bodies.’¹⁵

Since the prohibition against insider trading now applies to juristic persons, two fundamentally important questions need to be addressed:

- first, whether a Chinese Wall defence should be introduced into the SSA; and
- second, whether companies which repurchase their own shares should be regarded as ‘insiders’ of themselves.

These vital issues will now be considered.

2.1 The Chinese Wall Defence

A Chinese Wall is a technique used to prevent insider trading and to manage conflicts of interest which arise when financial business is carried on by a multi-functioning organisation.¹⁶ It is the creation of a physical and an operational segregation of functions within an organisation.¹⁷ This arrangement is set up in order to prevent information available to one group of persons or to a department in an organisation from becoming available to another group of persons or to another department in the same organisation. The rationale behind a Chinese Wall is to protect juristic persons from incurring liability for insider trading due to knowledge of their employees being attributed to them in law.¹⁸ The purpose of a Chinese Wall may be prophylactic, that is, to segregate information so that inside information attained by one group of persons in an organisation is not misused by another group in the same organisation, or its purpose may be legal, that is, if an organisation can demonstrate that it has established a system which seeks to ensure that information is not misused internally, this would constitute a legal

¹³ C 36.

¹⁴ The prohibition against insider trading in the UK is contained in Part V of the CJA. Our insider-trading legislation is to a large extent modelled on the CJA.

¹⁵ See *Gower & Davies Principles of Modern Company Law* 7 ed by Paul L Davies (2003) at 761.

¹⁶ See *Bolkiah v KPMG* [1999] 2 AC 222 [HL] at 238; Christopher M Gorman ‘Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?’ (2004) 9 *Fordham J of Corporate & Financial Law* 475, available at http://www.findarticles.com/p/articles/mi_ga4048/is_200401/ai_n9382780/print/.

¹⁷ See Lord Millet, Alistair Alcock, AJ Boyle, Leonard S Sealy & David A Bennett *Gore-Browne on Companies* 45 ed vol 2 (1986) (Supplement 53, Aug 2005) (‘*Gore-Browne on Companies*’) at 42.33.

¹⁸ See *Harrods Ltd v Lemon* [1931] 2 KB 157 (CA); Richard Jooste ‘Insider Dealing in South Africa’ (1990) 107 *SALJ* 588 at 597.

defence to an allegation of insider trading against that organisation.¹⁹ The specific policies and procedures of a Chinese Wall are determined by each organisation, taking into account the nature of its own business. For instance, in order to prevent communication between the various departments of a multi-service broker-dealer,²⁰ the firm could separate departments which have access to confidential information from departments which trade in securities or that give investment advice.²¹

Chinese Walls first came into existence in the United States of America in 1968 as part of a settlement agreement between Merrill Lynch, Pierce, Fenner & Smith Inc ('Merrill Lynch') and the American Securities and Exchange Commission (the 'SEC') in *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc.*²²

From about April through to July 1966, Merrill Lynch was the prospective managing underwriter of a proposed public offering by the Douglas Aircraft Company Inc ('Douglas') of USD 75 000 000 in convertible subordinated debentures. A registration statement for this offering was filed with the SEC on 7 June 1966 and became effective on 12 July 1966. Shortly after the filing, that is, sometime during the period 17 June 1966 to 22 June 1966, Douglas informed Merrill Lynch of certain material adverse information regarding Douglas' earnings, namely that Douglas would report substantially lower earnings for the first six months of its 1966 fiscal year than it had for the first five months of that year; that it had significantly lowered its estimate of earnings for its 1966 fiscal year; that it expected to have little or no profit for that year; and that it had substantially reduced its projection of earnings for its 1967 fiscal year. This information had not yet been made public but had been given to Merrill Lynch solely because of its position as the prospective underwriter for the debenture issue by Douglas. However, Merrill Lynch's underwriting department disclosed the information to persons in its institutional sales department, who in turn disclosed the information to several of Merrill Lynch's institutional customers. During the period 20 June to 23 June 1966, the institutional customers sold their shares in Douglas on the New York Stock Exchange to avoid substantial losses. These sales were made prior to the public disclosure of the revised earnings information by Douglas, which took place on 24 June 1966. The information about the adverse earnings which had been disclosed to Merrill Lynch by Douglas had not been disclosed to certain other customers of Merrill Lynch, for whom Merrill Lynch had been concurrently making purchases of shares in Douglas. The SEC instituted an

¹⁹ Michael Ashe & Lynne Counsell *Insider Trading – The Tangled Web* (1990) at 123.

²⁰ In a multi-service broker-dealer, the investment-banking department usually obtains material non-public information through its relationship with corporate clients. It then shares this information with the firm's retail brokers. The retail brokers, in turn, make trade recommendations to their customers based on this information. See further Gorman op cit note 16.

²¹ *Ibid.* In addition, organisations could restrict access to files and computers; use code words when discussing sensitive material; or physically lock up sensitive information or shred sensitive documents once they are no longer needed, to use a few examples: see Ashe & Counsell op cit note 19 at 117 and Gorman op cit note 16.

²² 43 SEC 933 (1968).

action against Merrill Lynch for a violation of SEC Rule 10b-5,²³ which rule was implemented under the American Securities Exchange Act of 1934. Merrill Lynch settled the legal action. As part of the settlement agreement reached between Merrill Lynch and the SEC, Merrill Lynch agreed to adopt a Statement of Policy which in future prohibited disclosure by any member of its underwriting division of material information obtained from a corporation which was not disclosed to the investing public by the corporation.²⁴

As pointed out by Poser, the SEC made it clear that its purpose in requiring Merrill Lynch to establish a Chinese Wall between its underwriting division and the other departments of the firm was to reduce the possibility that there would be further insider-trading violations by Merrill Lynch. Therefore, the purpose of the Chinese Wall was to be practical and prophylactic rather than legal.²⁵ Soon after this case, a broker-dealer attempted (unsuccessfully) to use its Chinese Wall as a legal defence.²⁶ In those jurisdictions, such as America and Australia, where the insider-trading prohibition applies to juristic persons,²⁷ statutory provision has been made for a Chinese Wall defence. For instance, s 1043F of the Australian Corporations Act, 2001, permits bodies corporate to raise a Chinese Wall as a defence by providing the following:

'Chinese wall arrangements by bodies corporate

A body corporate does not contravene subsection 1043A(1)²⁸ by entering into a transaction or agreement at any time merely because of information in the possession of an officer or employee of the body corporate if:

- (a) the decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than that officer or employee; and
- (b) it had in operation at the time arrangements that could *reasonably be expected* to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information; and
- (c) the information was not so communicated and no such advice was so given.' (my emphasis)²⁹

Similarly, in America, SEC Rule 14e-3,³⁰ a rule implemented under the Securities Exchange Act, embodies a Chinese Wall defence. Rule 14e-3(a) prohibits trading on the basis of non-public information regarding tender

²³ 17 Code of Federal Regulation ('CFR') §240.10b-5 ('Rule 10b-5'). This Rule was adopted to implement s 10(b) of the Securities Exchange Act of 1934, which prohibits the use of manipulative and deceptive devices or contrivances in the sale or purchase of securities in contravention of the rules and regulations prescribed by the SEC.

²⁴ *Merrill Lynch, Pierce, Fenner & Smith Inc.* supra note 22 at 938.

²⁵ Norman S Poser 'Chinese Walls or Emperor's New Clothes (2)' (1988) 9 *The Company Lawyer* 159 at 160.

²⁶ See *Slade v Shearson, Hammill & Co Inc* CCH Fed SEC L Rep 193, 329 (SDNY 1974).

²⁷ See ss 1042B and 9 of the Australian Corporations Act, the former section which explicitly refers to a body corporate, and s 3 of the American Securities Exchange Act, which defines 'person' as meaning 'a natural person, company, government, or political subdivision, agency, or instrumentality of a government'.

²⁸ Section 1043(A)(1) of the Australian Corporations Act prohibits an insider who possesses inside information from applying for, acquiring, or disposing of Division 3 financial products, or entering into an agreement to apply for, acquire or dispose of Division 3 financial products and from procuring another person to do so. Division 3 financial products include securities (s 1042A of the Australian Corporations Act), which is further defined in s 92 of the Australian Corporations Act as including shares.

²⁹ A similar defence exists in respect of partnerships: see s 1043G of the Australian Corporations Act.

³⁰ 17 CFR §240.14e-3 ('Rule 14e-3').

offers, which is the most important type of material non-public information involved in insider trading cases.³¹ Rule 14e-3(b) exempts juristic persons from this rule if the individual making the investment decision on behalf of such juristic person did not have knowledge of the material, non-public information, and the juristic person had

‘implemented one or a combination of policies and procedures, *reasonable under the circumstances*, taking into consideration the nature of the person’s business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a) of this section, which policies and procedures may include, but are not limited to,

- (i) those which restrict any purchase, sale and causing any purchase and sale of any such security; or
- (ii) those which prevent such individual(s) from knowing such information’. (my emphasis)

Poser correctly points out that these defences are limited in that the arrangements contemplated must be such that they could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision, or are reasonable under the circumstances.³² Consequently, even if a juristic person had erected a Chinese Wall, should the Wall not be considered to be reasonable under the circumstances and should it have been supplemented with other measures, or if the Wall is reasonable under the circumstances but did not go far enough and ought to have comprised stricter elements, the juristic person will fail in its reliance on its Chinese Wall as a defence against insider trading. It seems, therefore, that even though the Australian Corporations Act and the American Securities Exchange Act have made provision for Chinese Wall defences, these defences do not necessarily absolve juristic persons from liability for insider trading.

The courts, particularly in the United Kingdom and in Australia, have assessed the effectiveness of Chinese Walls in several cases dealing with conflicts of interest in firms of solicitors and accountants. It may be useful to examine the courts’ attitude in these cases regarding the efficacy of Chinese Walls in general.

It is evident that the majority of the courts have expressed scepticism about Chinese Walls and have come to the conclusion that the Walls that had been erected were not effective in the circumstances of the particular case. For instance, in *Supasave Retail Ltd v Coward Chance*,³³ Browne-Wilkinson VC observed that ‘[e]xperience in this court demonstrates that the maintenance of security on either side of Chinese walls in the context of the city does not always prove to be very easy [and] . . . is a very difficult task’. The learned judge further stated that when one has sensitive information in a firm or in any other group of people, there is an element of seepage of that information through casual chatter and discussion, and the letting slip of information

³¹ See MS Blackman, RD Jooste & GK Everingham *Commentary on the Companies Act* vol 1 (2002) at 5.394.3.

³² Poser op cit note 25 at 162.

³³ [1991] Ch 259 at 270.

which may not be thought to be relevant in itself but may constitute a vital link in a chain of causation or line of reasoning.³⁴

In the Australian case of *Mallesons Stephen Jacques v KPMG Peat Marwick*,³⁵ pp J, in referring to the practice of erecting Chinese Walls, mentioned that '[i]t is a practice that apparently emanates from the United States of America, having been devised by large firms of lawyers in an attempt to justify representation of conflicting interests at the same time [but the practice] has been subject to considerable criticism and scrutiny there'.

In *Bolkiah v KPMG*³⁶ the House of Lords expressed the view that to attempt to place an information barrier between members who are drawn from the same department and who have been accustomed to working with each other, is particularly difficult. And in *Re a firm of Solicitors*,³⁷ Parker LJ in the Court of Appeal went so far as to assert that 'save in a very special case such as *Rakusen's* case, I doubt very much whether an impregnable wall can ever be created and I consider that it is only in very special cases that any attempt should be made to do so'.

In *Rakusen v Ellis Munday & Clark*,³⁸ a Chinese Wall was successfully relied upon as a defence to a conflict-of-interest situation in a law firm. In this case, M & C were the only two partners in a law firm. They had separate practices, each with his own clients, without any knowledge of the other's clients and with the exclusive services of some of the clerks. R consulted M in a certain matter, but after he had terminated his mandate with M, C, who had never met R and was not aware that he had consulted M, was retained by the opposite party in the same matter. R objected to this appointment on the ground that he had disclosed confidential information to M. While the Court a quo granted an interdict to restrain C from acting against R, the Court of Appeal found that there was no risk of a leakage or misuse of confidential information even if C acted for the opposite party. However, an undertaking had to be given that C would act in his own name and not in that of the partnership. The decision in *Rakusen* has been examined in several subsequent cases, but has not been followed in them because the unusual facts in *Rakusen's* case have been found to be distinguishable.³⁹ It was suggested in *Mallesons'* case that what was essential to *Rakusen's* case was the dissociation and separation of C from the partnership.⁴⁰

It is submitted that the conclusion that may be drawn from an examination of the prevailing jurisprudence on the issue is that while it may be possible to create an airtight Chinese Wall (as was done in *Rakusen's* case), it is very difficult to do so in practice. Although Chinese Walls may have the advantage

³⁴ At 268.

³⁵ (1990) 4 WAR 357 (SC, WA) at 371-2.

³⁶ Supra note 16 at 239.

³⁷ [1992] 1 All ER 353 (CA) at 363.

³⁸ [1912] 1 Ch 831(CA).

³⁹ See, eg, *Bolkiah v KPMG* supra note 16 at 233; *Bolkiah v KPMG* (1999) 1 BCLC 1 (Ch D, CA & HL) at 26; *Re a firm of Solicitors* supra note 37 at 363; and *Mallesons v KPMG* supra note 35 at 373.

⁴⁰ *Mallesons v KPMG* supra note 35 at 373.

of being perceived as an admirable attempt to enforce fairness and confidence in the market by ensuring that insiders are not able to engage in dishonest transactions⁴¹ and by attempting to mitigate conflict-of-interest situations experienced especially by multi-service broker-dealers,⁴² they are nevertheless very difficult to implement successfully in practice. Some of the disadvantages of Chinese Walls will be discussed shortly.

In agreement with Poser, it is submitted that the effectiveness of a Chinese Wall inevitably decreases to the extent that decisions concerning different areas of a firm's business are made by the same persons.⁴³ The effectiveness of Chinese Walls has consequently been questioned in smaller firms.⁴⁴ In *Rakusen's* case, where the firm in question was a small one, it may be that the Chinese Wall was nevertheless effective because the two partners of the firm had carried out completely separate practices, which is uncommon. In contrast, the difficulty in larger firms is that the rules and procedures comprising the Chinese Wall tend to be very complicated and elaborate and thus very difficult to monitor effectively.⁴⁵

A Chinese Wall cannot prevent an intentional disclosure of inside information,⁴⁶ although, as Gorman submits, it may curtail the accidental flow of information.⁴⁷ Ultimately, the effectiveness of a Chinese Wall is dependent on the honour system and the ethical values of the particular persons involved. In *North & South Co v Berkeley*,⁴⁸ Donaldson J questioned whether persons could really be trained to act with integrity once they had been placed in a conflict situation. As emphasised by Poser,⁴⁹ where the financial stakes are high, the reality is that even if compliance officers are diligent, their efforts may be futile in instances where senior management is less committed to compliance than to maximising the profits of their organisation. By their very nature, Chinese Walls impose barriers to the exchange of information and consequently information or expertise in one department of an organisation firm would not be accessible to another department.⁵⁰ If an organisation is not able to share information among its different departments, it may lose out on the advantages gained from collective thinking and from integrating different

⁴¹ Gorman op cit note 16.

⁴² A broker-dealer often finds himself in a situation where the firm's interests conflict with those of its clients, or where the interests of two of the firm's clients conflict: see *ibid*.

⁴³ Norman S Poser 'Chinese Walls or Emperor's New Clothes (3)' (1988) 9 *The Company Lawyer* 203 at 204.

⁴⁴ Jooste op cit note 18 at 598.

⁴⁵ Poser op cit note 43 at 204.

⁴⁶ *Re a Firm of Solicitors* supra note 37 at 367. According to a study by the University of Michigan Business School on Chinese Walls in securities firms which are intended to prevent such firms from exchanging information between their market-making and brokerage activities and their corporate finance, investment banking and advisory functions, it was found that information continues to flow between departments despite the creation of such Walls. The study employed data from all insider transactions in publicly listed firms from 1975 to 2000 to test the effectiveness of Chinese Walls. See Ann Arbor 'Chinese Walls Fail to Curb Conflicts of Interests in Securities Firms' (13 Feb 2003), available at <http://www.umich.edu/news/Releases/2003/Feb03/r021103a.html>.

⁴⁷ Gorman op cit note 16.

⁴⁸ [1971] All ER 980 (QBD) at 991.

⁴⁹ Poser op cit note 43 at 205.

⁵⁰ Ashe & Counsell op cit note 19 at 121.

departments.⁵¹ Moreover, with modern information technology and the involvement of personnel with specialist knowledge of particular financial instruments in both the research and trading functions of an organisation, the distinction between those functions is fast becoming blurred.⁵² As a result, maintaining feasible barriers between these functions is becoming increasingly challenging.

More importantly, a Chinese Wall cannot prevent insider trading by inside officers and their tippees, which, as emphasised by Gorman,⁵³ continues despite the erection of such a Wall and is very common. In some instances, a Chinese Wall may have the disadvantage of preventing customers of a multi-service firm from acquiring certain information which it would be in their interests to acquire. For instance, a broker-dealer firm has a duty of loyalty to its customers, which entails disclosing to its customers all material facts within its knowledge. A Chinese Wall may prevent retail traders of the broker-dealer firm from using information obtained from investment bankers to comply with this duty.⁵⁴

This is illustrated by *Slade v Shearson, Hammill & Co*⁵⁵ where a broker-dealer had established a Chinese Wall but was unsuccessful in relying on it as a defence when an action under Rule 10b-5 was brought against it. Shearson, a broker-dealer, had received negative information about an investment banking client, Tidal Marine International Corporation ('Tidal Marine') at a time when the firm's retail salesmen were soliciting customers to buy Tidal Marine shares. Shearson did not disclose this information to its customers and permitted recommendations of the shares to continue. A retail customer who claimed to have bought Tidal Marine shares on the recommendation of the salesmen employed by the firm at the time when the firm had possessed the negative information, brought an action against Shearson under Rule 10b-5. Shearson's defence was that its Chinese Wall had prevented the communication of the information to its retail brokerage department. It argued that because of the Chinese Wall, the non-public information in the possession of the firm's investment banking department should not be imputed to the firm and that the firm therefore did not breach its duty of loyalty to its retail customers. However, the Court rejected this defence. It held that Shearson had voluntarily entered into conflicting fiduciary relationships with retail customers and corporate clients, and that it could not recognise its duty to one while disregarding its duty to the other.⁵⁶ As *Slade v Shearson* illustrates, it is not clear that a Chinese Wall defence would in fact protect a juristic person

⁵¹ Gorman op cit note 16.

⁵² See the Australian Companies and Securities Advisory Committee *Discussion Paper on Insider Trading* (2001) in par 2.193.

⁵³ Gorman op cit note 16.

⁵⁴ Ibid.

⁵⁵ Supra note 26.

⁵⁶ The District Court referred a question to the Second Circuit Court which found that there were at least three unresolved factual issues and that instead of one legal question, there was a complexity of interlocking questions. It accordingly remanded the case for additional fact finding without responding to the question. See *Slade v Shearson, Hammill & Co* 517 F 2d 398 (2d Cir 1974).

from an allegation of insider trading brought against it.⁵⁷ For example, would it be a good defence to a claim in negligence that those persons advising a client are not aware of the information, because of a Chinese Wall, which with the exercise of reasonable care, they ought to have been aware of and which would have protected the client's interests?⁵⁸

It is submitted that the disadvantages of Chinese Walls considerably outweigh their advantages. It is accordingly submitted that the SSA ought not to follow the example of Australia and the United States of America by introducing Chinese Walls as a legal defence to the offence of insider trading. In fact, the Australian *Discussion Paper on Insider Trading* considered whether the Chinese Wall defence should be removed from the insider-trading provisions for the reason that it is becoming increasingly difficult to erect and maintain airtight knowledge barriers within an organisation.⁵⁹

However, if a Chinese Wall defence is not introduced in South African law, it would nevertheless still be necessary to protect juristic persons from knowledge of their employees being imputed to them in the context of insider trading. It is submitted that Poser's suggestion that one way in which to minimise this problem is to make it mandatory for juristic persons to make full and prompt public disclosure of all material non-public corporate information in their possession, ought to be adopted in South Africa.⁶⁰

As simplistic and unrealistic as it may seem, if inside information is eliminated, insider trading would be eliminated.⁶¹ Insider-trading abuses that arise from the conflict-of-interest problem experienced by broker-dealer firms would also be significantly reduced as all parties to the transaction would have access to the same information.⁶² This would moreover accord with Rule 3.4 of the Listings Requirements of the JSE Limited, which requires listed companies, without delay, to release an announcement providing details of any development in their sphere of activity that is not public knowledge and which may lead to material movements of the reference price of the listed securities of such companies (unless the information is kept confidential for a limited period of time in terms of Rule 3.6).⁶³

⁵⁷ *Slade's* case illustrates the difficult situation that a Chinese Wall places broker-dealer firms in. If the firm complies with its Chinese Wall in order to avoid liability for insider trading, it is subject to an action by its retail customers for failing to disclose the information. But if the firm discloses the information to its retail customers in order to fulfil its duty to disclose all material facts, it faces an action from its corporate clients for disclosing the information in violation of its duty of confidentiality. See Gorman op cit note 16.

⁵⁸ See *Gore-Browne on Companies* op cit note 17 at 42.33.

⁵⁹ See the Australian Companies and Securities Advisory Committee op cit note 52 in par 2.193.

⁶⁰ Poser op cit note 43 at 208.

⁶¹ *Ibid.*

⁶² Gorman op cit note 16.

⁶³ Rule 3.6 of the Listings Requirements of the JSE Limited provides that a listed company may provide price sensitive information to its sponsors, advisers, and/or any persons with whom it is in negotiations with a view to effecting a transaction or raising finance. These persons may include prospective underwriters of an issue of securities, providers of funds or loans or potential placees of the balance of a rights issue not taken up by shareholders. In such cases, the listed company must advise the recipients of such information that the information is confidential and that it constitutes inside information.

Of course, it is not always feasible or desirable to disclose all material information immediately and disclosure would result in a loss of confidentiality in some instances.⁶⁴ In such cases, as suggested by Gorman, the company could apply for an exemption from this requirement,⁶⁵ but even a lenient disclosure requirement would eliminate the need for a Chinese Wall.⁶⁶

In addition, it is submitted that it should be a requirement of the SSA that juristic persons must maintain a restricted list of securities. For instance, when a broker-dealer firm enters into an underwriting or other financial involvement which is likely to result in the receipt of inside information by it, the firm would be required to cease any discretionary trading for its customers in the securities of the company and to place those securities on a restricted list.⁶⁷ This would have the effect that an employee at the firm would not be permitted to make recommendations or solicit trades for a security which has been placed on this list.⁶⁸ If a customer had to make an inquiry about such a security, he would be informed that the firm is neither able to make recommendations nor give advice relating to that security.⁶⁹ In order to overcome the obvious problem that arises with the placing of a security on a restricted list, namely that it may alert customers that the firm has inside information about that security (more particularly, adverse information in the case where the firm had previously recommended that security), firms should place the security in question on the restricted list as soon as they enter into any relationship which is likely to result in them receiving inside information.⁷⁰ Poser concedes that a restricted list is not an ideal solution as it has a disadvantage for the firm in that it reduces its ability to compete in the marketing of securities, and as it has a disadvantage for the customer in that it narrows the range of investment advice which may be received from the firm.⁷¹ Nevertheless, as suggested by Poser, a restricted list would go some way towards reducing a misuse of material non-public information.⁷²

2.2 Share Repurchases

There has been some debate on whether or not a company which repurchases its own shares is an ‘insider’ of itself. Companies in America which engage in share repurchases whilst in possession of inside information, are potentially liable for insider trading.

In *Shaw v Digital Equipment Corp*,⁷³ the Court stated that, in the same way as an individual insider with material non-public information about pending

⁶⁴ See Poser op cit note 43 at 208 and Gorman op cit note 16.

⁶⁵ Gorman op cit note 16.

⁶⁶ Ibid.

⁶⁷ Poser op cit note 43 at 208.

⁶⁸ Gorman op cit note 16.

⁶⁹ Ibid.

⁷⁰ Poser op cit note 43 at 209.

⁷¹ Ibid.

⁷² Idem at 208.

⁷³ 82 F 3d 1194 (1st Cir, 1996) at 1204.

merger negotiations could not purchase his company's securities without making a disclosure, the company itself may not engage in such a purchase of its own stock if it is in possession of such undisclosed information.

Cassim has suggested in 1999 that all companies, whether or not their shares are listed on the stock exchange, ought to be declared 'insiders' for the purposes of the prohibition against insider trading and should be subjected to the liability imposed by insider-trading legislation so as to compensate the seller of shares who suffers loss by selling his shares to the company as a result of the company's use of confidential information which is not public knowledge.⁷⁴ This would, of course, not apply to unlisted securities as these fall outside of the scope of the SSA, although it could be of relevance to the common law liability of insider trading.

However, an alternative view was expressed in the Australian case of *Exicom Pty Ltd v Futuris Corp Ltd*⁷⁵ where Young J ruled that a company cannot be an insider in relation to its own shares as

'the theory behind insider trading is breach of fiduciary duty [T]he whole genesis of this aspect of the law from the law of fiduciary obligation shows that one does not owe a fiduciary obligation to oneself. I do not consider that the company itself is an insider.'

However, the Australian insider-trading provisions are not confined to persons who have a fiduciary link with the company whose securities are traded, nor do they require that there be a breach of a fiduciary duty for insider trading to take place.⁷⁶ Moreover, if one of the rationales of insider-trading legislation is that persons who trade in securities should have equal access to information and that persons with an information advantage should not be permitted to exploit it by trading, then a company that repurchases its own shares is in no different position from any other person dealing in shares.⁷⁷

It is submitted that companies which engage in share repurchases should be considered insiders of themselves in relation to their own shares. Shareholders of a company should be protected against a company taking advantage of non-public price-sensitive information to repurchase their shares at a lower price than what the company would have had to pay if the information were to be publicly available as that has the effect of benefiting shareholders who do not sell their shares back to the company.⁷⁸ There is little doubt that the company is the ultimate insider.⁷⁹

In America, SEC Rule 10b5-1, implemented under the Securities Exchange Act,⁸⁰ allows companies to repurchase their shares without running the risk of insider trading, but only if the directors make the decision for the company to

⁷⁴ See FHI Cassim 'The New Statutory Provisions on Company Share Repurchases: A Critical Analysis' (1999) 116 *SALJ* 760 at 777.

⁷⁵ (1995) 18 ACSR 404 (SC, NSW) at 408-9.

⁷⁶ See the Australian Companies and Securities Advisory Committee op cit note 52 in par 2.110.

⁷⁷ HAJ Ford, RP Austin & IM Ramsay *Ford's Principles of Corporations Law* 12 ed (2005) in par 24.470 at 1256.

⁷⁸ See the Australian Companies and Securities Advisory Committee op cit note 52 in par 2.114.

⁷⁹ New Zealand Law Commission Report No 9 *Company Law Reform and Restatement* (Jun 1989) in par 413 at 100.

⁸⁰ 17 CFR §240.10b5-1.

repurchase its shares before obtaining any inside information and if they exercise no further influence over the scheme. It is submitted that a similar provision ought to be introduced in the SSA as this would make it feasible for companies to repurchase their own shares without running the risk of committing the offence of insider trading.

3 The Offences of Insider Trading

The SSA preserves the offences of insider trading which had existed in the ITA. These offences are:

- dealing in securities for one's own account while in possession of inside information;
- dealing in securities on behalf of another person while in possession of inside information;
- disclosing inside information to another person; and
- encouraging or discouraging another person to deal.

However, the SSA has introduced amendments that may at first blush seem to be slight nuances to these offences and to their defences, but which may in fact may have a significant impact on the prohibition against insider trading. The offences of insider trading and their defences in the SSA are examined below.

3.1 The Offence of Dealing

Sections 73(1)(a) and 73(2)(a) of the SSA make it an offence for an insider who knows that he has inside information, to deal in securities⁸¹ listed on a regulated market⁸² for his own account or for any other person. Section 73(1)(a) provides as follows:

'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.'

Section 73(2)(a) reads:

'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.'

3.1.1 The Meaning of 'dealing'

The ITA did not contain a definition of the acts which constitute the act of 'dealing'. The SSA has introduced a non-exhaustive definition of 'dealing'

⁸¹ The definition of 'securities' is set out in s 1 of the SSA. Money market instruments have been expressly excluded from the definition (except for the purposes of ch IV of the SSA, which deals with the custody and administration of securities).

⁸² Section 72 defines a 'regulated market' as meaning 'any market, whether domestic or foreign, which is regulated in terms of the laws of the country in which the market conducts business as a market for dealing in securities listed on that market'. This is discussed in more detail below.

but, disappointingly, it provides merely that ‘deal’ ‘includes conveying or giving an instruction to deal’.⁸³ The word ‘includes’ in the definition of ‘deal’ indicates that the act of dealing entails more than conveying or giving an instruction to deal, but one is still left in the dark as to precisely what would constitute the act of dealing. Presumably, dealing would include acquiring and disposing of securities, but it is not clear if it goes further than this. For instance, does abstaining from dealing constitute the offence of dealing? If a person does not acquire shares which he would otherwise have acquired because he had inside information that the shares were going to fall in value, would this constitute dealing? Similarly, if a person did not sell shares which he would otherwise have sold because he had inside information that the shares were going to increase in value, would this constitute dealing?

Abstention from dealing does not constitute an offence under the English CJA. The view has been expressed that the reason for this is the severe evidential problems that a prosecution would face if abstention from dealing constituted an offence.⁸⁴ However, it is submitted that while this may be true, it should not result in an abstention from dealing not being punishable in those instances where a prosecution would be able to produce sufficient evidence of the abstention from dealing. The loss of public confidence in the market would be as strong as in a case of dealing if news of the abstention were to emerge.⁸⁵

It moreover seems paradoxical that discouraging another person to deal, which is not an offence under the CJA, does constitute an offence under the SSA.⁸⁶ Thus, if a person is encouraged to abstain from dealing, the person encouraging the abstention from dealing commits an offence,⁸⁷ yet abstaining from dealing in itself is not punishable.

Unlike the SSA, s 55(1) of the CJA provides a detailed definition of ‘dealing’. It states that a person ‘deals’ in securities if

- (a) he acquires or disposes of the securities (whether as principal or agent); or
- (b) he procures, directly or indirectly, an acquisition or disposal of the securities by any other person’.

In terms of the CJA, ‘acquire’ includes *agreeing* to acquire the security, and entering into a contract which creates the security.⁸⁸ Likewise, ‘disposal’ includes *agreeing* to dispose of the security and bringing to an end a contract which created the security.⁸⁹ A person procures an acquisition or disposal of a security if the security is acquired or disposed of by a person who is his agent, nominee or a person who is acting at his direction,⁹⁰ in relation to the acquisition or disposal, but this is not exhaustive as to the circumstances in which a person may be regarded as procuring an acquisition or disposal of

⁸³ Section 72 of the SSA.

⁸⁴ Gower & Davies op cit note 15 at 770.

⁸⁵ Ibid.

⁸⁶ Section 73(4) of the SSA.

⁸⁷ The offence gives rise to both civil and criminal liability.

⁸⁸ Section 55(2) of the CJA.

⁸⁹ Section 55(3) of the CJA.

⁹⁰ Section 55(4) of the CJA.

securities by another.⁹¹ From the definition of ‘dealing’ and, more specifically, the definition of ‘acquire’ and ‘disposal’ in the CJA, it seems that an individual could conceivably commit the offence of dealing if he simply *agrees* to acquire a security or *agrees* to dispose of the security. The offence would be committed at the time that the individual agrees to acquire or dispose of the security and it is irrelevant that the relevant contract is never executed.⁹² If, therefore, an individual, after agreeing to acquire or dispose of the security, subsequently changes his mind and does not acquire or dispose of the security, he will nevertheless have committed the act of dealing. This seems somewhat curious in light of the fact that abstention from dealing does not constitute an offence under the CJA.

It is not clear whether the Legislature intended the act of dealing under the SSA to extend to a mere agreement to acquire or to dispose of securities, or whether dealing is to be limited to the actual acquisition or the disposal of securities and the conveying or the giving of an instruction to acquire or dispose of securities.

3.1.2 ‘Directly or indirectly’

Section 73(1)(a) of the SSA, like s 2(1)(a) of the ITA, makes it an offence to deal ‘directly or indirectly’ for one’s account in the securities listed on a regulated market to which the inside information relates. But s 73(1)(a) refers to dealing directly or indirectly or ‘through an agent’. It is not clear why exactly the words ‘or through an agent’ have been added as presumably dealing ‘indirectly’ would have covered dealing through an agent.⁹³

Perhaps the Legislature inserted these words in s 73(1)(a) to make it abundantly clear that if one deals through an agent, such a dealing would constitute the offence of ‘dealing’ in s 73(1)(a) of the SSA. If so, then the question arises why the words ‘or through an agent’ were not inserted after the words ‘directly or indirectly’ in s 73(2)(a) of the SSA, which deals with the offence of dealing on behalf of another person. It is doubtful that the Legislature’s intention was to provide that the offence of dealing for another person could not be committed through an agent, as one could conceivably deal on behalf of another person through an agent. It is accordingly submitted that the words ‘or through an agent’ in s 73(1)(a) are superfluous but not necessarily innocuous for the reason that so long as they are in the section, they are subject to judicial interpretation, which is not always predictable.

3.1.3 Defences to the Offence of Dealing

Section 73(1)(b) sets out the defences which may be raised to the offence of dealing for one’s own account and which must be proved on a balance of

⁹¹ Section 55(5) of the CJA.

⁹² *Gore-Browne on Companies* op cit note 17 at 42.25.

⁹³ Blackman, Jooste & Everingham op cit note 31 at 5.394.27.

probabilities, whether in a civil or a criminal action. The subsection provides as follows:

‘An insider is, despite paragraph (a), not guilty of any offence contemplated in that paragraph if such insider proves on 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 4(1) of the ITA, in contrast, contained four defences which could be raised to the offence of dealing for one’s own account. In terms of that measure an individual would not have been guilty of the offence of dealing if such individual could prove on a balance of probabilities that he or she

- ‘(a) was acting on specific instructions from a client, save where the inside information was disclosed to him by that client;
- (b) would have acted in the same manner even without the inside information;
- (c) 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 foreign exchange services; or
- (d) was acting in pursuit of the completion or implementation of an affected transaction as defined in section 440A of the Companies Act, 1973 (Act 61 of 1973).’

The first three defences of s 4(1) set out above no longer apply to the offence of dealing for one’s own account. The defences set out in ss 4(1)(a) and 4(1)(c) would not be applicable to dealing for one’s own account, but, as will be discussed shortly, the defence set out in s 4(1)(b) would certainly apply to dealing for one’s own account. To this extent there has been a significant tightening of the defences available to an insider who deals for his own account.

The fourth defence of s 4(1) has been reproduced in s 73(1)(b)(i) of the SSA but with a slight amendment: the words ‘or implementation’ which appeared in s 4(1)(d) of the ITA have not been reproduced. The effect of the omission of these words is not clear. The question that arises is whether it is the intention of the Legislature to limit the application of the defence to the pursuit of the *completion* only of an affected transaction,⁹⁴ that is, would the defence apply only if, for instance, one were at the end-stage of an affected transaction, once the implementation of the affected transaction had taken place?

It is submitted that the defence ought to apply at any stage of one’s involvement in an affected transaction, and that there appears to be no cogent reason why it should now be restricted to the completion of an affected transaction. In the recent case of *S v Western Areas Ltd & Others*,⁹⁵ the Court held that, on a proper interpretation of s 4 of the ITA, the defences set out there, particularly the one set out in s 4(1)(d) which was in issue before it, clearly presupposes lawful conduct on the part of an accused in the pursuit of

⁹⁴ An ‘affected transaction’ is defined in s 440A(1) of the Companies Act 61 of 1973. Briefly it is a transaction which involves a change of control of a company.

⁹⁵ [2006] 2 All SA 653 (W).

the completion (or the implementation) of an affected transaction.⁹⁶ It is submitted that this statement would be equally applicable to the equivalent defence set out in s 4(1)(d) of the ITA which has been reproduced in s 73(1)(b)(i) of the SSA.

A new defence to the offence of dealing has been introduced in s 73(1)(b)(ii), namely that the insider only became an insider after he or she had given the instruction to deal to an authorised user⁹⁷ and that the instruction was not changed in any manner after he or she became an insider. In other words, the defence is that the accused had not given an authorised user an instruction to deal because of the inside information, but that the accused had acquired the inside information only after he had given the authorised user the instruction to deal and he did not change the instruction after having acquired the inside information.⁹⁸

An insider who deals on behalf of another person may raise the following defences, set out in s 73(2)(b) of the SSA:

‘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) 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;
- (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.’

The defence set out in s 73(2)(b)(i) reproduces the defence set out in s 4(1)(a) of the ITA with the difference that now only authorised users may rely on this defence. However, it is not only authorised users who act on specific instructions from clients,⁹⁹ and therefore the scope of this defence has been limited significantly.

⁹⁶ *Idem* at 667c-e.

⁹⁷ An ‘authorised user’ is defined in s 1 of the SSA as meaning ‘a person authorised by an exchange in terms of the exchange rules to perform such securities services as the exchange rules may permit’. For example, a stockbroker would be an authorised user. An ‘exchange’ is defined as meaning ‘a person who constitutes, maintains and provides an infrastructure –

- (a) for bringing together buyers and sellers of securities;
- (b) for matching the orders for securities of multiple buyers and sellers; and
- (c) whereby a matched order for securities constitutes a transaction’.

A ‘transaction’ is a contract of purchase and sale of securities.

⁹⁸ Unlike the CJA, it is not a defence in the SSA that the person did not expect the dealing to result in a profit attributable to the price-sensitive information (cf s 53(1)(a) of the CJA). This defence also applies to the offence of encouraging another person to deal in securities (see s 53(2)(a) of the CJA) and to the offence of disclosing inside information (see s 53(3)(a) of the CJA).

⁹⁹ For instance, if a person were to instruct his attorney to deal in certain listed securities on his behalf and such attorney instructs an authorised user to acquire the securities at a time when the attorney had inside information about the securities in question (which inside information was not disclosed to him by his client), the attorney would be dealing indirectly in securities on behalf of another person, contrary to s 73(2)(a) of the SSA. However, the attorney would not be able to rely on the defence set out in s 73(2)(b)(i) that he was acting on specific instructions from a client, since the attorney is not an ‘authorised user’ as defined in s 1 of the SSA.

The defence set out in s 73(2)(b)(ii) of the SSA is a replication of that in s 4(1)(c) of the ITA and also of that in s 63 of the CJA, save that both the ITA and the CJA refer to 'foreign' exchange reserves whereas s 73(2)(b)(ii) refers to 'external' exchange reserves. Under the CJA this defence applies to all the offences of insider trading, but in the SSA it is a defence only to the offence of dealing on behalf of another person. The purpose of this defence is to exclude the activities of the Government in the management of the economy from the ambit of the insider-trading prohibition.¹⁰⁰

The defence which previously existed in s 4(1)(b) of the ITA, that is, that the individual would have acted in the same manner even without the inside information, has been rather surprisingly excluded altogether from the SSA. Sections 53(1)(c) and 53(2)(c) of the CJA contain a similar defence, that is, they exempt an individual from liability for the offence of insider trading if he is able to prove that 'he would have done what he did even if he had not had the information'.

This defence served the useful purpose of protecting innocent trades, non-discretionary trades and automatic trades.¹⁰¹ For instance, it would apply to an individual who decides to buy or sell certain securities and subsequently, but before buying or selling those securities, obtains inside information that supports his previously reached decision.¹⁰² It would also protect an individual who sold securities in order to meet pressing financial obligations, or acquired or sold securities in order to fulfil a legally binding obligation incurred prior to the inside information having been acquired.¹⁰³ It would moreover protect individuals who find themselves in the course of their offices advised to trade at a time when they are already in possession of inside information.¹⁰⁴ For example, an insolvency lawyer who has to liquidate all the assets of an insolvent company could rely on this defence if he has inside information about the securities he has to sell.¹⁰⁵ A further example of an individual who could have relied on this defence is that of an agent who at the time he possesses inside information, is instructed by his principal to deal in securities when his principal had no knowledge of the inside information. The agent would commit the offence of dealing if he dealt in the securities, but he would have been able to rely on the defence that he would have acted in the same manner even without the inside information.¹⁰⁶

It is unfortunate that these categories of persons are no longer protected

¹⁰⁰ *Gore-Browne on Companies* op cit note 17 at 42.14.

¹⁰¹ PC Osode 'The New South African Insider Trading Act: Sound Law Reform or Legislative Overkill?' (2002) *J of African Law* 239 at 251.

¹⁰² Australian Companies and Securities Advisory Committee op cit note 52 in par 2.72.

¹⁰³ Blackman, Jooste & Everingham op cit note 31 at 5.394.28.

¹⁰⁴ Gower & Davies op cit note 15 at 772.

¹⁰⁵ Richard Jooste 'The Regulation of Insider Trading in South Africa – Another Attempt' (2000) 117 *SALJ* 284 at 296.

¹⁰⁶ Stephanie Luiz 'Insider Dealing in the United Kingdom: Some Comments and Some Comparisons' (1995) 7 *SA Merc LJ* 204 at 214. The agent cannot rely on the defence set out in s 73(2)(b)(i) of the SSA if he is not an authorised user because only an authorised user can rely on the defence that he was acting on specific instructions from a client.

under the SSA. It is a further instance of the tightening of the defences provided for in the Act.

3.2 Disclosing Inside Information: The Disclosure Offence

Section 73(3)(a) of the SSA sets out the disclosure offence as follows:

‘An insider who knows that he or she has inside information and who discloses the inside information to another person commits an offence.’

The disclosure offence is committed at the point when the insider discloses the information to another person, whether or not he intends or suspects that the person to whom he has disclosed the information will or will not deal.¹⁰⁷

The ITA contained an offence to the same effect in s 2(2). However, the defence to the disclosure offence in the SSA has been significantly tightened compared to the defence which was provided for in the ITA. The defence to the disclosure offence is provided for in s 73(3)(b) which provides that an insider is not guilty of the offence contemplated in s 73(3)(a) 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 on a regulated market and that he or she at the same time disclosed that the information was inside information’.

In contrast, in terms of s 4(2) of the ITA, an individual would not have been guilty of the disclosure offence if such individual proved on a balance of probabilities that he or she

- ‘(a) believed, on reasonable grounds, that no person would deal in the securities or financial instruments as a result of such disclosure; or
- (b) disclosed the inside information in the proper performance of the function of his or her employment, office or profession and at the same time disclosed that the information was inside information’.

The defence in s 4(2)(a) of the ITA has not been reproduced in the SSA. This defence was subjective as the belief of the insider was relevant and it was probably difficult to prove. Yet, s 53(3) of the English CJA contains a similar defence to the equivalent offence of disclosing inside information.¹⁰⁸ The defence set out in s 4(2)(b) of the ITA has been reproduced in s 73(3)(b) of the SSA but, as mentioned above, the defence in s 73(3)(b) has been tightened. The additional element which must now be proved by the offender on a balance of probabilities is that the disclosure was made in circumstances unrelated to dealing in any security listed on a regulated market. It is submitted that the insertion of this additional requirement may create difficulties in practice.

For instance, in the context of a situation where Company A is interested in acquiring 51 per cent of the issued share capital of Company B, which

¹⁰⁷ *Gore-Browne on Companies* op cit note 17 at 42.27.

¹⁰⁸ The prohibition against disclosing inside information is contained in s 52(2)(b) of the CJA, but the difference between this section and the prohibition contained in the SSA is that before the offence can be said to have been committed under the CJA, it has to be proved by the prosecution that the disclosure was not in the proper performance of the functions of the accused’s employment, office or profession.

company is listed on the JSE Limited and is in favour of such acquisition, but where Company A wishes to conduct a due-diligence investigation into the affairs of Company B before making the acquisition, it would seem that the directors of Company B would commit the disclosure offence simply by permitting Company A to conduct the due-diligence investigation into the affairs of Company B and that they would not be able successfully to rely on the defence provided in the SSA to the disclosure offence. To analyse this situation more closely: The directors of Company B would fall within the definition of 'insiders' as they would have inside information through being directors of the listed company to which the inside information relates. If they know that they have inside information, which they would, and they were to disclose the inside information to Company A, they would clearly commit the disclosure offence set out in s 73(3)(a) of the SSA. In order to rely on the defence to the disclosure offence provided in s 73(3)(a), the directors of Company B would have to prove all three elements of the defence on a balance of probabilities.

- The first element that must be proved is that the information was disclosed because it was necessary for the directors to disclose it for the purpose of the proper performance of the functions of their employment, office or profession. If the board of directors of Company B considers the acquisition of Company A to be in the best interests of Company B, and accordingly authorises the disclosure, the directors would be complying with their fiduciary duty to act in the best interests of Company B by disclosing the inside information. The person actually making the disclosure would presumably act in accordance with a board resolution. It is submitted that this would satisfy the element of the information being disclosed by the relevant insider because it was necessary to do so for the proper performance of the functions of his employment, office or profession.
- The second element that must be satisfied in order for this defence to apply is that the information must be disclosed in circumstances unrelated to dealing in any listed security. The purpose of disclosing the information in the context of a due-diligence investigation would be for Company A to decide whether or not to proceed with the acquisition of Company B. The disclosure is arguably related to dealing in the listed securities of Company B because if Company A were satisfied with the outcome of its due-diligence investigation it would in all likelihood deal in the listed securities of Company B. The directors of Company B would not be able to rely on the defence to the disclosure offence should they fail to prove this second element of the defence. It is submitted that the defence to the disclosure offence is much too restrictive if its effect is that information disclosed in the context of a due diligence investigation would constitute insider trading. It moreover seems absurd that, according to the defence set out in s 73(3)(a)(i) which permits an insider to deal in securities if he proves that he was acting in pursuit of the completion of an affected

transaction, Company A would be entitled to proceed with the acquisition of shares in Company B notwithstanding the fact that it possessed inside information at the time since the acquisition by Company A of 51 per cent of the share capital of Company B would constitute an affected transaction, and the acquisition would fall within the defence provided in s 73(1)(b)(i) of the SSA, but Company B now incurs the risk of committing the disclosure offence by disclosing information to Company A in the context of a due diligence investigation. It is submitted that the 'dealing' contemplated in the second element of the disclosure defence must be understood to mean dealing which is not related to the completion of an affected transaction, in order to avoid an anomaly in the legislation, and so as to be logically consistent with s 73(1)(b)(i).

- The third element of the defence that must be proved by Company B, one that had previously existed in s 4(2)(b) of the ITA, is that it had disclosed, at the time of the disclosure to Company A, that the information constitutes inside information.

It is clear from the above analysis that difficulties may be encountered by a company that discloses inside information to another company in the course of a due-diligence investigation as such a disclosure could constitute insider trading. It is doubtful that the Legislature could have intended that the addition of the words 'in circumstances unrelated to dealing' in the defence to the disclosure offence should have this effect since a due-diligence investigation is undeniably an essential step of any acquisition.

In terms of the ITA, an accused had the right to raise any defence other than those set out in the ITA.¹⁰⁹ But the SSA does not confer on an accused a right to raise any defence other than that provided for in the Act itself. This is most regrettable as there may be instances where one may justifiably rely on a defence that is not provided for in the SSA, such as in the case of the scenario set out above, where an anomaly arises in that an insider is permitted to deal in the pursuit of the completion of an affected transaction but is prohibited from disclosing inside information in the pursuit of the completion of an affected transaction. One wonders whether this was not due to an oversight on the part of the Legislature.

3.3 Encouraging or Discouraging Dealing

Section 73(4) of the SSA repeats s 2(2) of the ITA, which makes it an offence to encourage or discourage a person from dealing in securities listed on a regulated market. Section 73(4) provides as follows:

'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.'

¹⁰⁹ Section 4(3) of the ITA provided that the 'defences set out in subsections (1) and (2) are not intended to be the only defences available in any proceedings under this Act'.

As was the case under the ITA, the words 'encourage' and 'discourage' are not defined in the SSA. Presumably encouraging or discouraging another person from dealing could take place by words or by conduct.¹¹⁰ The more subtle the encouragement or discouragement, the more difficult it would be to prove.¹¹¹

The inside information itself need not be disclosed in order for one to commit the offence of encouraging another person to deal or discouraging another person from dealing.¹¹² If the person who has been encouraged to deal, does in fact deal without having received the inside information, he would not be guilty of committing the offence of dealing under s 73(1)(a) or s 73(2)(a) of the SSA as the dealing offence requires the possession of inside information on the part of the dealer,¹¹³ and as such a person must himself be an insider. It does not matter that the person who is encouraged or discouraged deals or does not deal in the securities as a result of the encouragement: merely encouraging or discouraging another to deal in securities constitutes an offence.

This may be contrasted with the position under the CJA, which makes it an offence to encourage another person to deal in securities in circumstances where the individual doing the encouragement knows, or has reasonable cause to believe, that dealing will take place.¹¹⁴ As mentioned previously, discouraging or stopping another person from dealing is not an offence under the CJA.

Unlike the position under the ITA, the SSA does not provide any defence to the offence of encouraging or discouraging dealing. Under the ITA, the same defences that could have been raised to the offence of dealing could also have been raised as a defence to encouraging or discouraging dealing.¹¹⁵

In contrast, the CJA has provided defences to the offence of encouraging another person to deal. One defence is that the individual would have done what he did even if he had not had the information.¹¹⁶ Another defence is that the individual believed at the time on reasonable grounds that the information had been or would be disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having the information.¹¹⁷ The SSA does not contain such a defence which in the United Kingdom is known as a 'closed circles' defence.¹¹⁸ One type of transaction with which this defence is concerned is that of underwriting a secondary offer, where it would be possible for some parties to the dealing not to possess the

¹¹⁰ Luiz op cit note 106 at 208.

¹¹¹ Ibid.

¹¹² Ibid.

¹¹³ Jooste op cit note 105 at 295.

¹¹⁴ Section 52(2)(a) of the CJA.

¹¹⁵ Section 4(1) of the ITA.

¹¹⁶ Section 53(2)(c) of the CJA.

¹¹⁷ Section 53(2)(b) of the CJA.

¹¹⁸ Keith Wotherspoon 'Insider Dealing – The New Law: Part V of the Criminal Justice Act 1993' (1994) 57 *Modern LR* 419 at 430.

inside information without there being any mischief.¹¹⁹ For example, an employee of an organisation might commit his employer to underwrite an offer subject to approval by the employer's board of directors, and the board may approve the deal on the basis of the employee's recommendation without knowing much about the contents of the offer document.¹²⁰

It is not clear why the SSA has not provided any defences at all to the offence of encouraging and discouraging dealing. It is submitted that the offence in s 73(4) is too harsh and would result in practical difficulties. For example, to use the scenario referred to earlier, if a person were to disclose information to another person in the context of a due-diligence investigation done as a preliminary step to a take-over, it is arguable that that person would thereby be encouraging or discouraging the other person from dealing in securities since that other person would deal (or not deal) in the securities, based on the outcome of the due-diligence investigation. Since no defence may be raised to the offence set out in s 73(4) of the SSA, such a person would commit an offence simply by permitting another person to conduct a due-diligence investigation into his affairs. This would be ludicrous.

It is submitted that this goes further than necessary. Hitherto, the defence in s 4(1)(d) of the ITA could have been raised in this situation, that is, that such person was acting in pursuit of the completion or implementation of an affected transaction. This, sadly, is now no longer an option.

4 The Application of the Insider Trading Provisions to Foreign Markets

The offences of insider trading under the SSA, like those under the ITA,¹²¹ apply only to 'securities listed on a regulated market'. Such a market is defined in s 72 of the SSA as meaning 'any market, whether domestic or foreign, which is regulated in terms of the laws of the country in which the market conducts business as a market for dealing in securities listed on that market'.

According to s 72, the Act would apply even to securities listed on a foreign market. This is certainly not unintentional, as may be seen from the *Memorandum on the Objects of the Insider Trading Bill, 1998*, which states, as one of its objects, that the Bill will embrace financial instruments and securities listed on a regulated market, whether such market is regulated in South Africa or internationally.

Consequently, if a person is physically present in South Africa, but deals in a security that is listed on the London Stock Exchange while possessing inside information, such person may be sanctioned in terms of the SSA.¹²² Even if

¹¹⁹ House of Commons Standing Committee B, Fourth Sitting, 10 Jun 1993, col 163: see further Wotherspoon op cit note 117 at 430.

¹²⁰ Ibid.

¹²¹ See s 1 of the ITA.

¹²² Osode op cit note 101 at 260.

such person is not a South African citizen, or is not domiciled in South Africa, he or she would incur liability under the SSA. Similarly, if a person deals with a security listed on the London Stock Exchange acting through a broker based in London, and possesses inside information at the time, such person would incur liability under the SSA.¹²³

But the SSA goes even further than this. If, for instance, a person is resident in London and, while possessing inside information, deals in the shares of a company listed on the New York Stock Exchange, the South African Financial Services Board could pursue civil and criminal proceedings against the London-based trader. In this last example there is no territorial link to South Africa, yet an offence would be committed under the SSA. If the intention of the Legislature is to protect the South African financial marketplace and its local and foreign investors, the SSA goes too far in permitting the Financial Service Board to pursue, investigate and prosecute persons who commit the offence of insider trading while based in a foreign country and on a foreign market.¹²⁴

In striking contrast, in the United Kingdom, a territorial link must be established with the United Kingdom before an offence is committed under the CJA. In order for the dealing offence to be committed, the individual must either be physically present in the United Kingdom at the time that any act forming part of the dealing occurs, or the regulated market on which the dealing occurs must be one regulated in the United Kingdom,¹²⁵ or the professional intermediary with or through whom the offence was committed must be in the United Kingdom at that time.¹²⁶ Regarding the encouragement and disclosure offences, either the individual or the recipient must have been present in the United Kingdom at the time of the occurrence of the offence.¹²⁷ Similarly, under the Australian Corporations Act, a territorial link must exist with Australia in order for an insider trading offence to be pursued: either the prohibited conduct must occur in Australia, or, if the prohibited conduct occurs outside Australia, the relevant financial product¹²⁸ must be issued by a person who carries on business in Australia or by a body corporate which has been formed in Australia.¹²⁹

It seems rather odd that the SSA should not require a territorial link with South Africa to be established before an offence is committed. It is not clear how the South African market would benefit from a prosecution of a non-resident who deals in securities with inside information on a foreign

¹²³ *Ibid.*

¹²⁴ *Ibid.*

¹²⁵ The regulated markets are set out by the Treasury in the Insider Dealing Securities and Regulated Markets Order, 1994, SI 1994/187 as amended by SI 1996/1561, SI 2000/1923 and SI 2002/1874. They include the London Stock Exchange Ltd, LIFFE Administration & Management, and the exchange known as NASDAQ.

¹²⁶ Section 62(1) of the CJA.

¹²⁷ Section 62(2) of the CJA.

¹²⁸ The relevant financial products are referred to as 'Division 3 financial products': see note 28 *supra*.

¹²⁹ Section 1042B of the Australian Corporations Act.

market.¹³⁰ The cost, moreover, of pursuing such a prosecution on a global scale would surely be prohibitive.¹³¹

5 Penalties

Under the SSA the penalty imposed for committing an offence of insider trading (or market abuse) is a maximum fine of R50m (previously R2m under the ITA) and/or imprisonment for a maximum period of ten years.¹³²

Like the ITA (but unlike the CJA, which imposes criminal liability only), the SSA also imposes statutory civil liability for insider trading.¹³³ The SSA has set up an enforcement committee which is empowered to impose an administrative penalty, payable to the Financial Services Board, on a person who has contravened the SSA or who has failed to comply with the SSA.¹³⁴ Although to date there has not been a successful prosecution for insider trading in South Africa, credit must be given to the Financial Services Board for collecting out-of-court settlements from insiders, which may have had the effect of deterring insider trading to some extent.¹³⁵

However, it is conceivable that out-of-court settlement agreements may not be sufficient to discourage insider trading as the terms of the settlement agreements may allow the parties concerned to remain free from prosecution, and as many settlements are reached without any admission of liability. It remains to be seen whether the harsher penalties under the SSA will have the effect of more effectively deterring insider trading in South Africa. In a recent report of the United Kingdom's Financial Services Authority, it was stated that insider trading is rife on the London Stock Exchange, and that the scale of the fines imposed for insider trading there (which is presently GBP18 000) had proved to have had a limited deterrent effect.¹³⁶ It was suggested that visible-enforcement action was the key tool to curbing insider trading.¹³⁷ A suggestion well worth considering is that of a mandatory reporting requirement to the Financial Services Board of transactions consummated by insiders that involve listed securities and instruments issued by their

¹³⁰ See Osode op cit note 101 at 260.

¹³¹ Ibid.

¹³² Section 115(a) of the SSA.

¹³³ Section 77 of the SSA. The experience in the US has shown that civil liabilities are favoured compared to criminal liabilities because of the lighter burden of proof and the fact that it is easier to administer civil liabilities: see Derek Botha 'Control of Insider Trading in South Africa: A Comparative Analysis' (1991) 3 *SA Merc LJ* 1 at 18.

¹³⁴ See s 97 of the SSA.

¹³⁵ For instance, in a media release issued by the Financial Services Board and dated 7 Apr 2004, it was reported that it had reached an out-of-court settlement agreement with Deutsche Securities (Pty) Ltd in connection with price movements of shares of Datatec Ltd on or about 13 Apr 2000. The offence was alleged to have taken place under the ITA. Deutsche Securities had agreed to pay to the Insider Trading Directorate of the Financial Services Board an amount of R24m in full and final settlement. The settlement was made without admission of liability. See further http://ftp.fsb.co.za/public/insider/PRESS_Settle_DTC_Deutsche_2004-04-07.pdf.

¹³⁶ Reported by Barney Jopson in 'Insider Trading "rife" on London Stock Market' 18 Mar 2006 *Financial Times* at 3.

¹³⁷ Ibid.

companies.¹³⁸ Undoubtedly, insiders who know that their insider-trading transactions would be publicly reported would be induced to refrain from concluding such transactions whilst in possession of inside information.¹³⁹

6 Conclusion

The SSA has certainly tightened-up the regulation of insider trading in South Africa. Juristic persons, including trusts and partnerships, may no longer get away with impunity by committing insider-trading offences as the prohibition of insider trading has been extended to such persons. Now that the SSA applies to juristic persons, it is submitted that the Act ought not to follow the example of some foreign jurisdictions of introducing Chinese Walls as a formal legal defence. Rather it should be mandatory for all juristic persons to make full and prompt disclosure of all material corporate information.

It is further submitted that juristic persons ought to be obliged to maintain a restricted list of securities, which would assist in reducing instances of insider trading.

Moreover, it is suggested that companies which engage in share repurchases should be considered insiders of themselves in relation to their own shares. In order to make it feasible for companies to repurchase their own shares without running the risk of committing the offence of insider trading, it is submitted that the SSA ought to follow the American example by introducing a provision that permits companies to repurchase their own shares if the directors make the decision for the company to repurchase its shares before obtaining any inside information, and if they exercise no further influence over the scheme.

But, in tightening the regulation of insider trading in South Africa, it is submitted that the SSA has gone too far in narrowing down the defences to the insider-trading offence. For instance, the SSA has repealed certain defences which had existed in the ITA, and that may now have the effect of exposing certain innocent groups of persons to criminal prosecution under the SSA. The Act seems to have introduced an anomaly into our law in respect of the defence to the disclosure offence, and it has completely eradicated the defences to the offence of encouraging or discouraging dealing. More importantly, the SSA has eradicated the reliance on defences which are not specifically permitted by it. This means that a person accused of insider trading would be limited to only those defences set out in the SSA, and no scope is now left for any other valid defence to be raised.

Disappointingly, the SSA has not rectified some of the perplexities that previously existed under the ITA. For instance, it is submitted that the SSA ought to have restricted the extra-territorial effect of the insider trading prohibition by requiring a territorial link with South Africa before an offence

¹³⁸ Osode op cit note 101 at 256.

¹³⁹ Ibid.

is committed under the SSA. It is further submitted that the SSA should have taken the opportunity to have shed some light on the meaning of 'dealing.'

While the harsh penalties introduced by the SSA may go some way toward deterring insider trading, they may not on their own be a sufficient deterrent. Perhaps, if they were to be coupled with a mandatory reporting requirement to the public of transactions consummated by insiders, such persons would think twice before engaging in insider trading practices.

It remains to be seen whether the provisions of the SSA relating to insider trading will indeed fulfil the objects of the SSA of increasing confidence in the South African financial markets and of promoting the international competitiveness of securities services in South Africa. But there is little doubt that the SSA may have gone too far in regulating insider trading and has left us with unnecessarily stringent insider-trading provisions that may not always be practical.
