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'INSIDER TRADING REGULATION': TO BE OR NOT TO BE?

BY

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Research dissertation presented for the approval of Senate in fulfillment of part of the requirements for the degree of Master of Laws in approved courses and minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Master of Laws dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

Signature:

Signed by candidate

DEDICATIONS

*This piece of written work is dedicated to my adorable angel **Tirenioluwa Adedurotimi** and to the loving memory of **Professor Mike Larkin: B. Com LLB H Dip (Company Law), Witwaterstand 1949 – 2007.***

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To The King Eternal, Immortal, Invisible, The Only God Be Honor And Glory Forever And Ever More!!!

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CHAPTER ONE

1.0 INTRODUCTION

Insider trading¹ may be defined as the act of trading in company securities by persons often referred to as insiders who by virtue of their relationship to the company, possess some information, not available to the public, but material to the securities concerned. For instance, insider trading occurs where a director knows that a company is in a bad financial state and sells his shares in it knowing that in a few days, a cut in the dividend payment will be made public. Likewise, the director will be an insider trader if on being informed before it was generally made public that the company has discovered oil on its own land, he buys more shares in the company with the hope of an increase in their market value as soon as the information is made public.²

There are two schools of thought with strong and divergent views on the effect of insider trading generally and particularly as it affects the stock market and the investing public. The proponents of the first school of thought encourage trading on insider information for its many advantages. According to them, the stock market generally feeds and grows on free flow of information. Disallowing insider trading would mean hampering the flow of trade. Furthermore, they have argued that insider trading is fundamental to capitalism because it pushes prices in the right direction, increases the number of transactions and provides the only real recompense for entrepreneurs.³ In addition, they are of the opinion that long-term investors stand a chance to benefit immensely from the act.⁴

¹ Also referred to in this study as 'the act' or 'the act of trading on insider information.'

² Joseph E. O Abugu: 'Company Securities: Law and Practice -Insider Trading and Capital Market Manipulation' University of Lagos Press, 2005 Page 235.

³ Hein Online— French and Rider 'Should Insider Trading be Regulated? Some Initial Considerations' (1978) 95 SALJ 79 Page 87.

⁴ H. G Manne: 'Insider Trading and the Stock Market' New York, The Free Press, (1996) Page 102. More on their arguments will be discussed in chapter five of this study.

The other school of thought vehemently advocates the outright prohibition of insider trading. Members of this school readily point to its⁵ negative effects. In fact, it seems to be the majority view that insider trading has done more harm than good and should be prohibited. This view is premised on the belief that insider trading threatens the securities market in that it undermines the legitimate expectation of fairness and honesty which are the foundations of public confidence.⁶

Regardless of the negative effects of insider trading as adjudged by its promoters, I believe that the benefits that flow from the act are not only meritorious but also highly commendable. Therefore, its prohibition initially through the general principle of common law and equity, and now by the various legislative instruments⁷ is void of fairness and equity. I frown at the legislation⁸ uncompromising prohibition of insider trading at the expense of its positive effects on investors, the corporation and the society in general.

Also, the legislation is not free from fundamental flaws. It⁹ has overtime suffered enormous structural and definitional setbacks, which has affected its smooth implementation.

In view of the above, this study seeks to support the act of trading on inside information as against its prohibition. The legislation forbidding insider trading is rife with certain shortcomings, some of which this study also intends to explore.

To achieve the above objectives, the study will give an overview of insider trading in its second chapter by examining the nature of inside information. It will discuss some of the major components of insider trading, viz. materiality of the information; the role of knowledge of inside information; unpublished price sensitive information and the

⁵ That is, insider trading.

⁶ Nnona G. 'International Insider Trading: Reassessing the Property and Feasibility of the U.S Regulatory Approach.' (2001) 27 North Carolina Journal of International Law and Commercial Regulation, 185. More on their arguments will be discussed in chapter four.

⁷ That is, diverse Insider Trading Act also referred to as 'the legislation.'

⁸ Diverse Insiders Trading Act enacted by different countries. For example: The South African Financial Services Board Act (Act 97 of 1990); The United States Securities and Exchange Act of 1934; The Nigerian Investment and Securities Act of 1999; The Japanese Financial Markets Abuse Act of 2002 et cetera.

⁹ The legislation.

effects of the common law fiduciary duty of disclosure on insider trading. The chapter will attempt to define an 'insider' properly so called. This is a very crucial aspect of the study because it offers an introduction into the subject matter of the research.

The third chapter will focus on the historical survey of insider trading regulation. It will begin with the efforts of the common law at curbing the activities of insiders as well as its¹⁰ inadequacies. The chapter will unveil the various statutory interventions on insider trading necessitated by the shortcomings of the common law. The essence of these chapters¹¹ is to give an in-depth perception of the concept of insider trading generally. This is a very fundamental aspect of the study because it will allow readers from all and sundry, particularly those with no legal background whatsoever to have a quick grasp and easier follow up of the subject matter under consideration.

In the fourth chapter, the study will explore some of the arguments against insider trading.

Finally, the fifth chapter will attempt to debunk these arguments by justifying the need for trading on inside information. It will also study some of the challenges to insider trading regulation.

At the conclusion of this study, the following questions should have been addressed:

- i. Who is an insider trader and what is the nature of inside information?
- ii. To what extent did the common law and equity curb the activities of insiders and was statutory intervention more effective?
- iii. What are the 'disadvantages' of trading on inside information?
- iv. What are the bases for justifying insider trading? Are these reasons cogent enough to allow the trading to be?

¹⁰ That is, the common law.

¹¹ Chapters two and three of this study.

It is essential to mention that the study will by and large focus on the South African legislation. However, legislation in other jurisdiction will also be examined by way of comparison.

CHAPTER TWO

2.0 AN OVERVIEW OF INSIDER TRADING

Insider trading refers to a practice in which an insider or a related party trade based on material non-public, price-sensitive information obtained during the performance of the insider's duties to the corporation, or otherwise in breach of a fiduciary duty or other relationship of trust and confidence or where the non-public information was misappropriated from the company.¹²

2.1 THE NATURE OF INSIDER INFORMATION

It is important to have a clear understanding of the kind of information that might result in insider trading. In Section 72 of the Securities Services Act¹³ of South Africa, insider information means:

- 'Specific or precise information, which has not been made public and which-
- (a) is obtained or learned as an insider; and
 - (b) if it were made public would be likely to have material effect on the price or value of any security listed on a regular market'¹⁴

For proper understanding of inside information, a look at the following components is necessary:

2.2 Materiality of the information

Although what constitutes '*material information*' as it relates to the subject matter of this research is yet to be settled, it is generally acceptable that inside information must be material. Rule 10b-5(b) of the United States Securities and Exchange Act of 1934¹⁵ states that 'it shall be unlawful for any person... to make any untrue statement of a

¹² Insider Trading U.S. Securities and Exchange Commission. Accessed May 7, 2008.

¹³ 36 Of 2004 (subsequently referred to in this study as 'SSA')

¹⁴ Blackman Jooste Everingham: 'Commentary on the Companies Act (2004) vol 1 Revision Service (subsequently referred to in this study as 'Blackman et al') 1 5-394-12.

¹⁵ subsequently referred to in this study as 'SEA.'

material fact or to omit to state a *material* fact necessary in order to make the statements made, ... in connection with the purchase or sale of any security.'

Similarly, section 56(1) (d) of the English Criminal Justice Act Part V of 1993¹⁶ whilst defining inside information states that "inside information" means information which ...if it were made public, would be likely to have a significant¹⁷ effect on the price of any securities.'

The concept of materiality cannot be successfully separated from the fiduciary duty of disclosure. The American courts, when determining the fact of materiality are of the view that '... the fact that the issuer attempted to keep the information secret makes it material.'¹⁸ Hence, the concept of materiality has been likened to the:

*'Sorting Hat embedded in many disclosure rules under the federal securities laws... where there is a duty to disclose a material fact, whether in accordance with mandatory disclosure rules or anti-fraud rules, the materiality of that particular fact determine whether an individual or entity is obliged to disclose that fact. Either the fact is material and must be disclosed, or it is not material and must not be disclosed.'*¹⁹

Furthermore, the test for materiality of information can be determined by 'market effect.' That is, whether the information is reasonably certain to have a substantial effect on the market price of the security.²⁰ Therefore, for information to be material, it must be one that is serious, highly important and has great impact on the price of any securities listed on the regular market. The information must be price sensitive.²¹

¹⁶ subsequently referred to in this study as 'CJA.'

¹⁷ Oftentimes, the word significant has been used to replace material. See The CPA Journal; An accountant's guide to the SEC's new insider trading regulations (accountant's liability) by Robert C. Rosen Page 3.

¹⁸ See Bernhard Bergmans Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and European Community (1991).

¹⁹ Joan MacLeod Heminway Professor of Law, Brown University 1982 'Materiality Guidance in the Context of Insider Trading: A Call for Action' American University of Law Review vol 52 2003 Page 1149.

²⁰ SEC vs. Texas Gulf Sulphur Co 401 F. 2nd 848.

²¹ SM Luiz 'Insider Trading Regulation - If at First You Don't Succeed...' (1999) 11 SA Merc LJ 142. Similar provision in sec 56(3) CJA.

It has been suggested that the standard governing materiality should be the objective standard of a reasonable man.²² This standard has largely been left to judicial determination and interpretation. For some time now, there has been only one judicially created legal standard for materiality determination under Rule 10b-5.²³ This is set forth-in **TSC Industries, Inc vs. Northway Inc**²⁴ where it was stated that:

'an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote...what this standard does contemplate is a showing of substantial likelihood that, under all circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'

Although the standard of materiality here is well settled, its interpretation and application are often ambiguous and attempts to clearly define materiality have failed partially because the task is too fact-dependent²⁵ and not even the SEA has offered guidance as to the substance of the definition.²⁶

2.3 Unpublished Price-Sensitive Information

Unpublished Price Sensitive Information is defined as:

*'information which relates to specific matters relating to or concerned (directly or indirectly) with that Company, that is not of general nature or of concern to the company, and is not generally known to those persons who are accustomed or would be likely to deal in those securities but which would if it were generally known to them be likely materially to affect the price of those securities.'*²⁷

²² Ibid.

²³ Of the United States of America Securities and Exchange Commission Rule implemented under the Securities and Exchange Act of 1934 (subsequently referred to in the study as 'SEC')

²⁴ 426 U.S. at 449.

²⁵ Joan MacLeod Heminway Op cit Page 1153.

²⁶ Joan MacLeod Heminway Op cit Page 1150.

²⁷ Section 614 (2) of the Companies and Allied Matters Act 1999: See also Branson D.M, "Insider Trading II; The British Regulation in the light of the American Experience" (1982) The Journal of Business Law, 414-420.

What constitutes unpublished price sensitive information is vague and elusive as the meaning of what is unpublished or generally unknown cannot be defined with precision.²⁸ What is essential however is that the information traded upon must be confidential and not available to the public at the time of trade.

Section 58 of the CJA gave stringent circumstances where information will qualify as been made available to the public. Similar provisions have been adopted in most jurisdictions. Under the South-African legislation:²⁹

(1) '...information is regarded as having been made public by circumstances, which include but not limited to, the following:

(a) when the information is published in accordance with rules of the relevant regulated market for the purpose of informing clients and their professional advisers;

(b) when the information is contained in records which by virtue of any enactment are opened to inspection by the public; or

(c) when the information is readily acquired by those likely to deal in any listed securities-

(i) to which the information relates; or

(ii) of an issuer to which the information relates; or

(d) when the information is derived from information which has been made public.

(2) Inside information which would otherwise be regarded as having been made public must still be so regarded even though-

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

(b) it is communicated only on payment of a fee; or

(c) it is only published outside the Republic.'

This is a step away from what was attainable prior to the Insider Trading Act³⁰ where there was uncertainty as to when price sensitive information was made public.

²⁸ Joseph E.O. Abugu; 'The Statutory War on Insider Dealings' The Commercial and Industrial Law Review vol 1 2002 114/115. Published by the Department of Commercial and Industrial Law; Faculty of Law, University of Lagos Nigeria.

²⁹ Section 74 of the SSA.

³⁰ No. 135 of 1998.

Hence, the court became saddled with the responsibility of determining this on a case-by-case basis by applying the reasonable investor's test. Nonetheless, section 58³¹ gave a clearer and more expanded definition of the term 'publication' as it relates to insider trading. However, there remain some uncertainties regarding 'publication.' For instance, whether publication in any official languages; radio and television; or in a financial journal only sold on subscription will suffice?³²

2.4 Fiduciary duty of disclosure

The fiduciary duty of disclosure has overtime come to play a vital role in the act of trading on inside information.³³

'A fundamental safe guard to the investors and creditors in modern company law is provided by the twin idea of *disclosure and publicity*. This idea permeates the functioning of the company and constitutes an essential requirement for the efficiency of most of the provisions of company legislation.'³⁴

This corporate law principle imposes a duty on the fiduciary not to use confidential information for personal gain or profit but to disclose it to his principal. Thus, 'liability is imposed not when the fiduciary gains the confidential information but when without disclosure to his principal he uses the information to purchase or sell securities'³⁵....'

In the case of *SEC vs. Texas Gulf Sulphur Co*,³⁶ based on the policy of equality of access to information, the court held that anyone in possession of material non-public information was duty bound to disclose it. Where he is precluded from such disclosure, his only option would be to abstain from trading on the said information otherwise; he may be liable for insider trading. This is known as the disclose-or-abstain rule. It is worthy to note that this rule (disclose-or-abstain rule)³⁷ is 'also applicable to anyone

³¹ Ibid.

³² Blackman et al Op cit Page 1 5-394-14.

³³ Luiz 'Prohibition Against Trading on Insider Information-The Saga Continues' (1990) 2 SA Merc LJ 328 330; where it was argued that it was more correct to speak of insider trading but of the act of trading on insider information.

³⁴ Akanki O; Legal and Practical Significant of Disclosure and Publicity of Company Information (1976-78)13-15. Nigerian Bar Journal 13.

³⁵ United States vs. O'Hagan 97 C.D.O.S 4931.

³⁶ 401 F2d 833 (2nd Cir 1968), cert denied 394 US 976 (1969).

³⁷ Blackman et al Op cit Page 1 5-394-2.

in possession of inside information *who may not be strictly termed an insider....*³⁸
The implication is that while it has on one hand expanded the category of insiders, it has on the other hand imposed the duty of disclosure even where there exists no fiduciary duty to do so.

In *United States vs. O'Hagan*,³⁹ O'Hagan's conviction was reversed on the ground that he owed no fiduciary duty to the company or its shareholders; hence, he was not liable for insider trading. The Supreme Court however re-instated his conviction and stressed that while he had no duty to the company and its shareholders, he did owe a duty to the source of his information.⁴⁰ A duty that requires disclosure and 'his failure to disclose his personal trading to Grand Metropolitan PLC and Dorsey...made his conduct deceptive.'⁴¹ The court in its wisdom expanded the disclosure duty beyond that owed to the principal, the company or the shareholders. According to the court, it extends to the source of the information and simultaneously to the investing public. 'In short, it seems the duty can be owed to virtually anyone with confidential information, so long as the *tip* is then used "in connection with a securities transaction."'⁴²

However, the position of the courts have shifted further so that an insider trader will only be liable for breach of duty to disclose only if there is a pre-existing fiduciary duty to that effect.⁴³ In *Dirks vs. SEC*,⁴⁴ reversing the court of appeal's decision that imposed liability on the investment analyst Raymond Dirks, the court stated that he 'could not be liable for insider trading because the information he received was not as a result of fiduciary breach and therefore, he had no duty to disclose it to the market.'⁴⁵

³⁸ Second circuit of the Federal court of Appeals in *Sec vs. Texas Gulf Sulphur Co.*

³⁹ 97 C.D.O 4913.

⁴⁰ Ignacio E Salceda and Brett Rodda 'Getting the Appropriate Misappropriators: An Analysis of the Supreme Court's Decision in *United States vs. O'Hagan* 1997.

⁴¹ *Ibid.*

⁴² *Ibid.*

⁴³ *Chiarella vs. United States* 445 US 222(1980)\ *Dirks vs. SEC* 465 US 646 (1983).

⁴⁴ 463 U.S. 646 (1983).

⁴⁵ *Ibid.*

Similarly, in *Chiarella vs. United States*,⁴⁶ the court overturned an employee's rule 10b-5 conviction because the employee had no direct fiduciary relationship with any of the target companies in which he traded. Justice Powell found that Chiarella's conviction could not be upheld because doing so imposed a duty of disclosure among all market participants who had some information that other traders might not have. The rationale behind this dictum could be that ideally, security analysts should be encouraged to make an effort to investigate companies and then communicate their findings to their investors⁴⁷ rather than wait to be spoon fed.

Still under the disclosure requirement, it is important to know that by Rule 14 e-3 of SEC, anyone with material non-public information regarding a tender offer has a duty to disclose the information to the market or abstain from trading.⁴⁸

2.5 Knowledge

Knowledge is an essential element required to establish the guilt of any person who deals on inside information. Section 73 of the SSA states as follows:⁴⁹

- 1(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."*
- 2(a) *'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(a) *'An insider who knows that he or she has inside information and who discloses the inside information to another person commits an offence.'*

⁴⁶ 445 U.S. 222 (1980).

⁴⁷ Op cit.

⁴⁸ See more on Rule 14e-3 in Blackman et al, 15-394-3.

⁴⁹ Subsection 1(a), 2(a) & 3(a).

However where he is able to prove the exceptions⁵⁰ on the balance of probability, he would be free from liability. These exceptions are as listed below:

(1) (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.’

(2) (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) 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.’

(3) (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 on a regulated market and that he or she at the same time disclosed that the information was inside information.’”*

⁵⁰ Section 73 (1) (b), (2) (b) and (3) (b) of SSA, 2004.

2.6 WHO IS AN INSIDER TRADER?

Section 72 of the SSA defines an insider to mean 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 company insider is therefore 'someone who has access to important information about the company that affects its stock price or might influence investors' decisions.'⁵¹

That is, persons who are sufficiently connected with the company that are likely to handle valuable inside information.⁵²

'The company executives obviously have material information. The vice President of a sales department, for example, knows how much the company has sold and whether it will meet the estimates, it has provided to investors. Others within the company also have material information. The accountant who prepares the sales forecast spreadsheet and the administrative assistant who types up the press release are also insiders...

The company senior management are insiders. So are some of the financial analysts. The sales people usually are also insiders... The individual in investor relations and/or public relations who prepares the public announcements also are insiders.

If the company is developing a new product that could be a big seller, the key people in the research & development team would also be considered insiders, provided the information they have is material...'⁵³

⁵¹ F. John Reh: 'Your Guide to Management' Management 101 Guide, about.com 2002.

⁵² (a) J.E.O.Abugu Op cit Page 114. (b) See also Re Cady, Roberts & Co (1961) 40 S.E.C 907. Here, it was held that the insider's obligation rests on "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for corporate purpose and not for the benefit of anyone..." Page 912.

⁵³ F. John Reh. Op cit.

These class of persons shall not buy, sell, or otherwise *deal* in the securities of the company (or a related company) which are offered to the public for sale or subscription.⁵⁴

Theoretically and in the actual course of events, a person who is not an insider may be given access to privileged information by some remote connection and thus be liable for insider trading. Such persons are **secondary insiders or tippees**. These are persons who *knowingly (directly or indirectly)* obtain unpublished price sensitive information from persons who are connected with a particular company with the knowledge that the connected person held the information by virtue of his connection with the company. Moreover, it is reasonable to expect the connected person not to disclose the information except for the proper performance of his official functions. These individuals are prohibited not only from dealing in the securities of the company but also in the securities of other companies with which the particular company is related or involved, actual or contemplated.⁵⁵ They include persons connected to the company officially for example, auditors, accountants, solicitors, brokers, bankers. Also included are public officers to whom the company may divulge price sensitive information under statutory obligation before such information becomes generally available to members of the public.

Various provisions in insider trading legislation however allows for circumstances where certain persons are exempted from liability even when they are in possession of unpublished price sensitive information. Such persons include:

- (a) *anyone who acts, while in possession of unpublished price sensitive information, otherwise than with a view to making profit or the avoidance of loss (whether for himself or another person) by use of that information;*
- (b) *an individual who has a duty to deal in the securities in the course of faithful exercise of his powers as a liquidator, receiver or trustee in bankruptcy;*
- (c) *any individual who obtain unpublished price sensitive information about securities in the course of his business as a stock broker provided the*

⁵⁴ Cf: The EEC Directives and the English Criminal Justice Act, 1993.

⁵⁵ See Section 88 of the Investment and Securities Act of 1999 (subsequently referred to in this study as 'ISA').

information was of a description which it would be reasonable to expect him to obtain in the ordinary course of his business and he deals in the securities in good faith and in the ordinary course of his business;

- (d) any individual who is in possession of unpublished price sensitive information is not prohibited from doing any particular thing in relation to any particular securities if the information was of a description which it would be reasonable to expect him to obtain in the ordinary course of that business and he does that thing in good faith and in the ordinary course of business;*
- (e) any individual shall not by reason only of having unpublished price sensitive information relating to a particular transaction, be prohibited from doing anything if he does things to facilitate the completion or the carrying out of the transaction...*
- (f) any individual acting on behalf of a corporate trustee or personal representative who deals in or advises on securities when he is knowingly in possession of unpublished price sensitive information relating to them, is presumed to be exempted...if his action is carried out on the advice of a person who appeared to him to be an appropriate person from whom to seek advice...⁵⁶*

Having explored the general characteristics of insider trading and attempted the definition of an 'insider,' I shall now proceed to the historical account of insider trading regulations in the next chapter. Also to be examined are the efforts as well as the shortcomings of the common law at dealing with some of the challenges of insider trading that necessitated the intervention of the statutes.

⁵⁶ See section 90/91 ISA.

PART TWO

CHAPTER THREE

3.0 HISTORICAL ACCOUNT OF INSIDER TRADING REGULATIONS

The Common law has no specific provisos dealing with insider trading. Rather, the general principles of common law and equity prevailed. These principles can be used in an attempt to regulate and curb the supposed excesses of insider trading. The principles are: (i) the fiduciary duties of loyalty and good faith, and (ii) the duties of care and skill⁵⁷ that exists between directors and shareholders. For the purpose of this study, I shall examine the fiduciary duties of loyalty and good faith.

3.1 FIDUCIARY DUTIES

This category of duties may be viewed under four different rules.

The first rule is to the effect that a director must act in good faith in what he believes to be in the interest of the company. He is prevented from gaining any advantage from his position as a director. Thus, in a sale or purchase of securities on behalf of a company, he is not expected to make secret profits,⁵⁸ but rather obtain the best selling price or ensure the most reasonable price for the securities. Therefore, where a fiduciary relationship exists, the director in exercising his powers must act bona fide in the best interest of the company. He may not, either during or after his service with the company, use for his own purpose, anything, including trade secrets and confidential information, entrusted to him for use on behalf of the company, otherwise it becomes an unauthorized use of inside information resulting in a breach of his fiduciary duty to the company.

⁵⁷ L. C. B. Gower: Principles of Modern Company Law fifth edition London: Stevens and Sons, Limited. 1954 at Page 551.

⁵⁸ Regal Hastings Limited vs. Gulliver [1967] 2 AC 1347.

The second rule is that a director must exercise his powers for proper purposes. In other words, his powers must be exercised for a given purpose, which must be proper.⁵⁹

According to Isaacs J:⁶⁰

'...It must be exercised as all such powers must be, bona fide, that is for the purpose for which it was conferred, not arbitrarily or at the absolute will of the directors, but honestly in the interests of the shareholders as a whole.'⁶¹

In *Hogg vs. Cramphorn Limited*⁶² where directors issued shares in order to set up a trust scheme which would discourage a take-over bid and also ensure their continued control of the company, Buckley J. following *Punt vs. Symons and Company Limited*⁶³ held that directors are not entitled to use their powers in issuing shares merely for the purpose of maintaining their control of the company or for the purpose of defeating the wishes of the existing majority shareholders. Thus, the directors' good faith was disregarded and held irrelevant in determining the propriety of purpose.⁶⁴

The third rule is that a director must exercise an independent and unfettered discretion.⁶⁵ Although issues will often arise for decision in which a director will necessarily have to rely to a large extent on the knowledge and experience of others, he must exercise an independent discretion in the sense that, having listened to what his colleagues have to say, he must always bring his own mind to bear on the issue, using such skill and judgment as he may possess.⁶⁶

Lastly, is the rule that a director must not place himself in a position in which his personal interests or duties conflict with that of the company. He is duty bound to disclose the opportunity he obtains in his capacity as a director to the company and

⁵⁹ Sasegbon Deji: Nigerian Companies and Allied Matters Law and Practice Dsc Publication Limited, Lagos. Printed by Kim Hup Printing Company Pte Limited Singapore, 1991 Page 435.

⁶⁰ Metropolitan Life Assurance Company Limited vs. Ure (1923) 33 C. L. R. 199 AT 127.

⁶¹ See also Rich J. in Mills vs. Mills (1938) 60 CLR 150 159.

⁶² [1966] 3 All E. R. 420.

⁶³ [1903] 2 Ch. 506.

⁶⁴ Sasegbon Op cit.

⁶⁵ See Coronation Syndicate Ltd vs. Lilienfeld and the New Fortuna Co Ltd 1903 TS 489.

⁶⁶ Blackman et al Op cit 1 5-394-20.

must therefore not use corporate property, opportunity or information for his own advantage. In *Canada Aero Services vs. O'Malley*,⁶⁷ a conflict of interest arose where the director of a company converted a project which the company was trying to negotiate, (but which was unlikely to succeed) to a new company formed by him. The court held him liable to account for the profits he had made. Also, in *Industrial Development Consultants vs. Cooley*,⁶⁸ Mr. Cooley, an architect and the managing director of *Industrial Development Consultants* (IDC) was asked to conclude a contract on behalf of his company. Rather, he resigned from the company on the ground of poor health in order to divert the contract to himself. The court held him liable and accountable to the company for the profits made.

It is worthy to know that despite the effort of the common law fiduciary duties of loyalty and good faith, it failed to prohibit insider trading.

3.2 INADEQUACIES OF THE COMMON LAW

The first inadequacy of the common law is the restrictive category of an 'insider.' Only directors, officers and persons who have direct relationship with the company are considered insiders. Persons who although they have no direct link with the company but are closely connected enough to have or deal on inside information are not considered insiders.⁶⁹ This singular fact questions the competence of the common law to control insider trading since such category of persons can freely trade on inside information without incurring liability.

Another shortcoming of the common law is the scope of the director's fiduciary duty. That is, whether the director's fiduciary duty is limited to the company as an entity or whether it extends to the shareholders and members of the company? In *Percival vs. Wright*,⁷⁰ some directors were negotiating to sell a company's

⁶⁷ (1973) 40 DLR (31) 371.

⁶⁸ Blackman et al Op cit 1 5-394-20.

⁶⁹ That is, the secondary insiders as discussed in chapter two of this research.

⁷⁰ (1902) 2 Ch 421.

undertaking to outsiders at a higher price per share. The shareholders offered to sell their shares to the directors without being aware of this information at the time. The directors on the other hand accepted the offer and purchased the shares without divulging any information to them.⁷¹ In an action brought by the shareholders to set aside the sale on the ground that the directors ought to have informed them of the negotiation, Swinfen Eady J held that:

‘the purchasing directors were under no obligation to disclose to their vendors or shareholders the negotiations which ultimately proved abortive. The contrary view would place the directors in a most invidious position, as they could not buy or sell without disclosing negotiations, a premature disclosure of which might well be against the best interest of the company. I am of the opinion that the directors are not in that position.’

According to him, it cannot be said that the directors dealt unfairly with the shareholders who approached the directors and even named the price they wanted to sell their shares.

Although *Percival vs. Wright* was only a decision of the lower court, it served as precedent mainly because the higher courts have not overruled it. Thus, in *Re chez NICO (Restaurants) Limited*,⁷² it was submitted that the directors owe no fiduciary duty to the shareholders and were therefore under no obligation to disclose to them relevant information with respect to the value of their shares. Similarly, ‘the majority rule’⁷³ in the American state courts can be measured parallel to the principle in *Percival vs. Wright* that the directors or officers owe a fiduciary duty only to the corporation and are therefore under no fiduciary duty to disclose inside information to the shareholders of the company.⁷⁴

From the above, it may be implied that generally, fiduciary duties are limited only to the company as a legal entity with its own rights and obligations. These duties do not extend

⁷¹ The shareholders.

⁷² [1992] BCLC 192 208.

⁷³ This is a rule that selects one or two alternative based on which has more than half the votes. It is a binary rule used most often in influential decision-making bodies, including the legislatures of democratic nations.

⁷⁴ Blackman et al Op cit 1 5-385. Similar decision was taken in *Du Pont vs. Du Pont* 242 Feb 98 (1917) at 136.

to members of the company or potential shareholders who may also suffer from the insider trading.⁷⁵ Thus, shareholders cannot bring an action against a director who by virtue of his position becomes privy to unpublished price sensitive information and uses the information to his advantage but their own loss.

Nevertheless, it is worthy to note that the decision in *Percival vs. Wright* has been a subject of extensive criticism. In the words of Professor Louis Loss,⁷⁶ this decision elevated 'the corporate ghost (*the persona ficta*) over the flesh and blood owners of the company and is a monument to the ability of lawyers to hypnotize themselves with their own creations.' In his opinion, at the commencement of the take-over negotiations, the directors 'became trustees for the sale for the benefit of the company and shareholders, and could not purchase the interest of an ultimate beneficiary without disclosing those negotiations.'

Handley J A⁷⁷ was of the view that there are good reasons behind the established rule that in general, a director's fiduciary duties are owed to the company alone. This is because if fiduciary duties owed by directors to their companies were also owed to the shareholders, directors would be subject to harassing actions brought by minority shareholders. Since in that event, each shareholder would have a personal right, and directors would be exposed to a multiplicity of actions. However, '*...this should not preclude the recognition of a fiduciary duty to shareholders in relation to dealings in their shares where this would not compete with any duty owed to the company.*'⁷⁸

The above argument is premised on the fact that there are in '...certain special circumstances where fiduciary duties, carrying with them duty of disclosure, can arise which place directors in a fiduciary capacity vis-à-vis the shareholders.'⁷⁹ Hence, '...the

⁷⁵ J.E.O Abugu Op cit Page 240.

⁷⁶ The Fiduciary Concepts as Applied to Trading by Corporate Insiders in the United States: 1970 33 MLR 34 40-41. See also Blackman et al Op cit 1 5-383.

⁷⁷ In the case of *Brunninghausen vs. Glavanics* (1999) 32 ACSR 294 301 CA(NSW). See also *Glandon Property Limited vs. Strata Consolidated Pty Ltd* (1993) 11 ACSR 543 CA(NSW); *Coleman vs. Myers* [1997] 2 NZLR 225 CA(NZ); *Neuberger J in Peskin vs. Anderson* [2000] 2 BCLC 1 14.

⁷⁸ *Brunninghausen vs. Glavanics* Supra.

⁷⁹ *Browne Wilkinson in Re chez NICO (Restaurants) Limited* [1992] BCLC 192 208. Blackman et al Op cit 1 5-383 -392.

fact that the relationship between director and shareholder does not of itself give rise to a fiduciary duty does not prevent such an obligation arising when the circumstances require it.⁸⁰ Rather, 'the duties that arise from such fiduciary relationships depend on the circumstances giving rise them.'⁸¹

Thirdly, it has been established that a director who makes use of confidential price sensitive information affecting the securities of a company for his own advantage is in breach of fiduciary duties and therefore liable to account for any profits made.⁸² In practice however, it is unlikely that the company would call him unless and until there is a change of control. Where this occurs because of a take-over, those who will benefit from any recovery of the profits are the successful take-over bidders and not the members of the company at the time of the director's breach.⁸³

Also, if one director commits a breach, the other directors may cause the company to take action against him. Nevertheless, most public companies are likely to avoid damaging publicity by persuading the errant director to resign "for personal reasons" and to go quietly.⁸⁴ Even where the director is in breach of any fiduciary duty, the penalties for such actions and the relief available to victims of insider trading under the common law is not commensurate with the offence.

In addition to the foregoing inadequacies, the common law principle did not accommodate 'dealing.' Thus, a director could transact on a stock exchange through a nominee and no seller would be able to link up his sale with a purchase.⁸⁵

The incompetence of the common law and equitable principles to deal with insider trading necessitated the enactment of legislation.⁸⁶

⁸⁰ Platt vs. Platt [1992] 2 BCLC 745 755-756. Blackman et al Op cit 1 5-383 -392.

⁸¹ Supra.

⁸² Industrial Development Consultants vs. Cooley Op cit.

⁸³ As illustrated in Regal Hastings Limited vs. Gulliver [1967] 2 AC134n, H. L.

⁸⁴ L. C. B. Gower Op cit Page 607-608.

⁸⁵ L. C. B. Gower Op cit Page 608. This is however an offence under the Insider Dealing Act and a breach of The Stock Exchange's Model Code and The Code on Take-overs and Mergers.

3.3 STATUTORY INTERVENTION ON INSIDER TRADING

The historical account of the legislation began with the United States of America⁸⁷ being the first country to put up a strong resistance to insider trading. This was because of the 1929 crash in the stock exchange market. The crash was widely attributed to the activities of corporate insiders. A United States Senate Committee report revealed that several persons in fiduciary positions had acted on inside information.⁸⁸ The U.S Congress therefore enacted the SEA with the aim of protecting the ordinary purchaser or seller of securities and maintaining a fair and honest market.⁸⁹ Hitherto, the different provisions of the SEA have proven to be more potent than the common law particularly section 16(a) and (b):

'Every person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security (other than an exempted security) which is registered pursuant to section 12, or who is a director or an officer of the issuer of such security, shall file the statements required by this subsection with the Commission (and, if such security is registered on a national securities exchange, also with the exchange).

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and on behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit

⁸⁶ See footnote 8.

⁸⁷ U.S.

⁸⁸ Senate Committee Report No 1455, 73rd Congress 2nd Session, 53 [1934].

⁸⁹ Articles in [1975] 32 Washington and Lee LR 571FF.

shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security based swap agreement (as defined in section 206B of the Gramm-Leach Bliley Act) involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.'

Hence, the company or any of 'its shareholders' may bring an action in the company's name against any person who trades on inside information thereby making him liable to account for any profit realized from such purchase or sale. This seems a great departure from the common law fiduciary duty owed to the company only. By section 16 of the SEA, there is no requirement that the plaintiff has to prove the use of inside information. Although not too many countries have adopted it, this provision has overtime proven to be the most effective under SEC.⁹⁰

The United Kingdom agonized over insider trading for several years but did not legislate against it until 1980.⁹¹ In 1945, the Cohen Committee in England recommended that it was unwise to impose liabilities on directors who dealt with the shares of their company because their position as directors exposes them to information about the company's affairs not available to other players.

By 1962, the Jenkins Committee adopted the Cohen Committee's report and further recommended that a director who is guilty of insider trading should pay compensation to an aggrieved person and be prevented from dealing in options in securities of his company.⁹² While the former recommendation was implemented, the latter was not. However, the Stock Exchange and the City Code on Takeovers and Mergers provide

⁹⁰ Loss 'Fiduciary Concept as Applied to Trading by Corporation -Insiders in the United State' (1970) 33 MLR 34 37-40.

⁹¹ L. C. B. Gower Op cit Page 607.

⁹² Report of the Committee on Company Law and Amendment 6659 of 1945 para 99(c).

sanctions against insider dealing.⁹³ The Code is primarily concerned with takeovers and mergers.⁹⁴

Finally, the Company's Act of 1980 regulated insider trading in the United Kingdom but by 1985 the Act was passed moving insider trading provisions to the Company Securities (Insider Dealing) Act of 1985. In 1993, Part v (ss 52-64) of the Criminal Justice Act repealed the Company Securities (Insider Trading) Act. The effect of this legislation⁹⁵ on insider dealing was that:

- (i) Companies and corporate bodies could not be liable; and
- (ii) Only criminal sanctions could be imposed on insider dealing and these sanctions mainly cover dealings made on a regulated market as defined by the Act. This seems to be a shift from the US regulation and may not adequately curb insider trading.

Regulation of insider trading in South Africa may be traced to the Millin Committee of 1945.⁹⁶ The Committee supported the view of the Cohen Committee that every company should keep a register where the number, description and amount of shares or debentures held by each director and any changes therein are recorded.⁹⁷ In 1970, the Van Wyk De Vries Commission recommended that where a director was guilty of insider dealing, other remedies should be available to the company.⁹⁸ Also recommended was that insider dealing in listed shares⁹⁹ should attract substantial penalties.¹⁰⁰

These recommendations were adopted into the Company's Act 61 of 1973 but the provision proved ineffective. The Company's Act then enacted section 440B that

⁹³ An effort by the Financial Committee of the London City Code to avoid legislative intervention by imposing "Voluntary Self Discipline."

⁹⁴ Any person who is privy to any preliminary takeover and merger discussion or to any intention to make an offer is prohibited from inside trading.

⁹⁵ That is, the Criminal Justice Act.

⁹⁶ Report of the Commission of Equity on the amendment of Companies Act UG 69 of 1945.

⁹⁷ Ibid para 14. Similar to Section 16 of the SEA. The provision was introduced as section 70 Nov into the 1926 Company Act.

⁹⁸ Ibid para 44-50.

⁹⁹ These shares are usually identical thereby causing the problem of determining the seller and the purchaser in relation to a particular contract of sale of shares. See also Blackman et al, 1 5-394-6.

¹⁰⁰ Ibid para 44-54.

established The Securities Regulation Panel.¹⁰¹ The Panel regulates The City Code¹⁰² on takeover and mergers issued by the London Panel on takeovers and mergers.¹⁰³ Rule 2.1 of The Code provides that:

‘secrecy shall be observed before the announcement of a firm’s intention to make an offer and that all persons privy to the confidential information, price sensitive information or otherwise, concerning an offer or contemplated offer shall treat that information as secret.’

Moreover, The Code provides that “all persons concerned in an offer or contemplated offer shall conduct themselves so as to minimize the chances of an accidental leak of information.” Without any doubt, the provision is crucial for the curtailing of insider trading especially because of the Panel’s powers to summon any person whom it believes will be able to furnish information on the subject of an investigation.¹⁰⁴ It¹⁰⁵ also has powers to interrogate such persons under oath. It has been submitted that:

‘in the absence of The Panel, with its wide powers of subpoena and interrogation, it is unlikely that the provisions relating to insider trading would be effective for the very nature of insider trading renders its detection very problematic and it is extremely doubtful whether the states on their own would have the expertise to police it.’¹⁰⁶

Still on the development of insider trading regulation in South Africa, the King Task Group¹⁰⁷ was established in 1995 to investigate insider trading. In October 1997, they came up with a final report. As part of their recommendations, The Financial Services Board should be established and saddled with the responsibility of administering the insider trading regulation.¹⁰⁸ The Insider Trading Act 135 of 1998 (ITA) was then enacted and by section 11, the Securities Regulation Panel and the Financial Service Board served as watch dogs of insider trading.

¹⁰¹ Also known as ‘The Panel.’

¹⁰² Also known as ‘The Code.’

¹⁰³ See the Explanatory note on Securities Regulation Code on Takeover and Mergers.

¹⁰⁴ The Panel seems to be a proper forum where complaints regarding insider trading may be lodged.

¹⁰⁵ The Panel.

¹⁰⁶ R. Jooste; ‘Insider Dealing in South Africa- The Criminal Aspects’ De Ratione, vol. 4 No. 1 Page 22 Winter 1990.

¹⁰⁷ Chaired by Mervyn E. King.

¹⁰⁸ Final Report by The Kings Task Group into Insider Trading Legislation in October 1997; para 5-8.

The criminal provisions of the ITA relied on the United Kingdom's Criminal Justice Act of 1993 (CJA) while the civil liability provisions relied on the United States of America's regulation.¹⁰⁹ The ITA however proved inadequate for so many reasons¹¹⁰ and was repealed by the Securities Services Act 36 of 2004 (SSA).¹¹¹ The SSA repealed the Stock Exchange Act of 1985; The Financial Market Control Act 55 of 1989; The Custody and Administration of Securities Act of 1992 and consolidated them into one measure. (It has been argued that what the Securities Services Act did was 'more than a consolidation of the Act.¹¹² It also amended the repealed laws in many important respects in order to correct and improve some of their provisions. By this means, it added a significant number of new provisions to previous measures).'¹¹³

The prohibition of insider trading in Australia is traceable to the revelation made by the Race Committee. The Securities Industrial Act of New South Wales first introduced the prohibition of insider dealing in 1970. In 1980, section 128(1) of the Securities Industrial Codes provided that:

'a person who at any time in the preceding six months, has been connected with a body corporate shall not deal in any securities of the body corporate if by reason of his so doing, the body corporate is in possession of information that is not generally acceptable and might generally affect the price of these securities.'

The Code prohibited all forms of dealing in or regarding the securities of a body corporate.¹¹⁴

The provision was largely reproduced in section 1002 of the original version of The Corporations Act of 1989.¹¹⁵ The Corporations Act seemed to partly remedy the

¹⁰⁹ Blackman et al Op cit 1 5-394-10.

¹¹⁰ R. Jooste; 'The Regulation of Insiders Trading in South Africa- Another Attempt' (2000) 117 SALJ.

¹¹¹ It came into effect on the 1st of Feb. 2005.

¹¹² The ITA.

¹¹³ Comment of Rehana Cassim; Lecturer at school of law; University of Witwaterstand Johannesburg. See also the Memorandum on the Objects of the Securities Services Bill, 2004 published as GN 1746 in GG 26684 18th Aug. 2004.

¹¹⁴ Gregory Lyon, Jean Du Plessis: 'Insider Trading Law in Australia' 2005 Page 5.

¹¹⁵ See Australian Studies in Law, Crime and Justice; Legislative and Judicial responses to Insider Trading [internet sourced].

problems that arose under the common law¹¹⁶ by prohibiting an officer, employee, former officer or employee from making improper use of information obtained by virtue of his or her position as an officer or employee of the company to obtain advantage for himself, (an advantage that is evidently detrimental to the body corporate).¹¹⁷

In Nigeria, chapter 5, Part XVII of the Companies and Allied Matters Act 1990 focused on insider trading regulation. This part was repealed and re-enacted in Part X of the Investment and Securities Act of 1999.¹¹⁸ By chapter 8 of the ISA, the Securities and Exchange Commission is responsible for investor protection; maintenance of fair and orderly securities market; and specifically for the protection of the integrity of the securities market against any abuse arising from the practice of insider trading.¹¹⁹ Thus, anyone in possession of material inside information must either disclose it to the investing public or abstain from trading on it.¹²⁰

In Japan, the law against insider trading was enacted for the first time in 1988 while Malta enacted the Insider Dealing and Market Abuse Act in 1994. The European Union directives¹²¹ effectively replaced the Act in 2002 by The Financial Markets Abuse Act.

From the foregoing, there is no doubt that the legislation is fast developing. Moreover, insider trading is also regulated at the international level. The International Organization of Securities Commission (**IOSCO**) published the Objectives and Principles of Securities Regulation in 1998.¹²² Statistics has it that more than 8570 of the world's securities and commodities market regulators are members.¹²³

IOSCO highlighted the objectives of good securities market to include:

¹¹⁶ Percival vs. Wright Op cit.

¹¹⁷ Section 232 (5&6).

¹¹⁸ ISA.

¹¹⁹ Section 8 J & M of the ISA.

¹²⁰ J.E.O Abugu Op cit Page 241-242.

¹²¹ The Insider Dealing and Market Abuse Act of 1988.

¹²² It was updated in 2003.

¹²³ Insider trading Wikipedia, free encyclopedia [internet sourced].

- (a) Investor protection;¹²⁴
- (b) Ensuring fair, transparent and effective market; and
- (c) Reduction of systemic risks.

The provisions of the legislation are apparently the same, with an ultimate aim to eradicate completely the practice of insider trading. This is to be achieved through the monitoring and controlling of unauthorized use of unpublished price sensitive information by persons who are actively involved in the day-to-day running of a company hence safeguarding the interest of the corporation, investors and the society in general. There is no gainsaying that the legislation has somewhat dealt with the challenges of the common law and equitable principles on insider trading.

For instance, the legislation has succeeded in expanding the categories of insiders beyond its limiting scope under the common law. Consequently, by section 57 of the CJA, 'an insider is a person who has access to inside information by him being a director, employee or shareholder of an issuer of securities; or having access to the information by virtue of his employment, office or profession; or the direct or indirect source of his information is a person who is actively involved in the day to day running of a company, hence safeguarding the interest of the corporation, investors and the society in general.'¹²⁵ The section accommodates the notion of secondary insiders¹²⁶ so that, *any person who is closely connected to a Company enough to have or deal in inside information is an insider.*¹²⁷

Also, unlike under the common law where a director's fiduciary duty is limited to the company,¹²⁸ section 16 of the SEA, extends these duties to the shareholders, members and even officers of the company.

¹²⁴ 'Investors protection' in this context means the investors should be protected from misleading, manipulative or fraudulent practices which of course includes insiders trading.

¹²⁵ Similar provision in section 72 of SSA; section 10b of SEA.

¹²⁶ Barry Alexander K. Rider, Yutaka Tajima & Fiona Ma - Commercial Law in a Global Context: Some Perspectives in Anglo-Japanese law 'A Comparative Analysis of Anti-Insider Dealing Legislation' Page 209.

¹²⁷ See Chapter two for more details.

¹²⁸ As was decided in *Percival vs. Wright* Op cit.

Furthermore, dealing is expressly prohibited under the legislation.¹²⁹ Consequently, an individual is guilty of insider dealing if he encourages another person to deal in securities that are price-affected securities or he discloses the information, otherwise than in the proper performance of the functions of his employment, office or profession, to another person¹³⁰ or he procures, directly or indirectly, an acquisition or disposal of the securities by any other person.¹³¹

Despite legislative effort at improving the common law and equitable principles with the aim of facilitating the prohibition of insider trading, the fact remains that legislation has not been able to silence the subject matter of this research.¹³² Rather, it¹³³ has consistently suffered endless criticisms¹³⁴ (even the writer is enthusiastic to join the queue of critics). Many reasons have been adduced by various scholars as to the inadequacies of statutory regulation on insider trading.¹³⁵ In addition to these, I am of the view that the drafts-men lack proper understanding of the concept of insider trading which results in their ignoring the substance and chasing mere shadows. They have disregarded the *spirit* and exerted too much energy on the *letter* forgetting that although the letter killeth, it is the spirit that giveth life.¹³⁶

The next chapter will attempt to examine some of the submissions of the proponents of the prohibition in the legislation.

¹²⁹ The common law did not make provision for this.

¹³⁰ Section 57 of CJA. See section 55 of CJA for the definition of 'dealing' and section 84 of ISA for further prohibition on dealing.

¹³¹ Section 55 (1) (b) of CJA.

¹³² That is 'the act of trading on insiders' information.'

¹³³ The legislation.

¹³⁴ H. G. Manne Op cit.

¹³⁵ This will be expounded upon in subsequent chapter.

¹³⁶ The New King James Version of the Holy Bible: II Corinthians 3 vs. 6.

PART THREE

CHAPTER FOUR

4.0 ILLS OF INSIDER TRADING

The proponents of outright prohibition or increased regulation of insider trading has consistently hinged their arguments on the negative impact of the practice on the company involved, the investors and society. Some of their arguments are:

4.1 Breach of Trust

One of the criticisms of insider trading is that it amounts to a breach of trust by corporate insiders. By virtue of their status as insiders, directors and officers stand in a position of trust derived from the fiduciary relationship that exists between them and the company. It is therefore a breach of fiduciary duty for corporate insiders to misappropriate inside information with the aim of advancing their own interest. The situation is worse where these insiders (or corporate trustees) benefit from the privileged information at the expense of the very beneficiaries of that trust (their own shareholders).

Generally, a fiduciary is a person who undertakes or assumes responsibility or is required by law to act for or on behalf of and in the interests of another. He stands in a fiduciary relationship to that other person, his beneficiary or principal. This relationship imposes fiduciary duties or obligations on him. The fact that he has control over part or the whole of the affairs of the beneficiary renders the beneficiary vulnerable to self-interested conduct on the part of the fiduciary. In other words, the fiduciary may not use his position to promote his own interests because the purpose of the fiduciary duties imposed on the fiduciary is to protect the beneficiary from this particular form of vulnerability.¹³⁷

¹³⁷Blackman et al Op cit Page, 1 5-394 12.

The fiduciary relationship requires the insider to act in good faith. If he must act at all, he must act in what he bona fide believes to be the interest of his beneficiary. To ensure that the fiduciary does not breach this core duty, the fiduciary relationship imposes a ring of prophylactic duties around him. For instance, he must not without the informed consent of his beneficiary, make any profit from his position other than his agreed remuneration, or otherwise act for his own benefit or the benefit of a third person.¹³⁸

These fiduciary duties seek to ensure that the position of an insider is used and that those powers are exercised for, the benefit of the company as a whole, and never for personal advantage. Out of the fiduciary relationship in which an insider stands to his company arise a duty of reasonably protecting the interests of the corporation; his paramount duty is to the corporation, and his personal pecuniary interests are subordinate to that duty.¹³⁹

The misappropriation of confidential information could well be considered as a breach of three fundamental fiduciary duties owed by an insider to the company. These are:

- a) duty not to misuse confidential information;
- b) duty not to compete with the company; and
- c) duty not to use corporate property for unauthorized or personal purposes.

Trading on inside information it would seem falls under the narrower ground of misuse of confidential information.

Information given or obtained by a director or an insider in confidence includes information about the company's affairs, which the company has not, or has not yet, disclosed in its financial statements. Because such information is not generally known, it may be of value to the director, most obviously for trading in the company's shares.¹⁴⁰

¹³⁸Blackman et al Op cit Page 1 5-394 14.

¹³⁹Blackman et al Op cit Page 1 5-394 17.

¹⁴⁰Blackman et al Op cit Page 1 5-394 18.

4.2 Unfairness

It has been argued that insider trading is a resentful practice because thereby some become wealthy with little (visible) effort, (some consider it ill-gotten gain). Insider traders can rack up in a few weeks what it takes most people a lifetime to earn. There is also something 'shady' about how they earn it. They profit from material information that is secret and not available to the public or other shareholders. Only a few 'privileged' insiders are allowed to profit by it. This practice, which borders on greed, gives the insider a consistent edge in trades executed with such material information and those without the information will be consistent losers in the market.¹⁴¹

The latter category of people, which includes the vast majority of investors, would slowly realize the loser game they are playing in this 'market for lemons' and would believe that all transactions are thus biased against them. Slowly the typical investor would desert the market, retarding or destroying important functions of the stock market like capital formation.

4.3 Harmful to the Company

Another argument put forward for regulation or prohibition of insider trading is the fact that the act is harmful to the company in a number of ways. Apart from injuring the firm's reputation, insider trading may also lead to delay in the transmission and disclosure of information or the taking of corporate action. In other words, it¹⁴² provides incentives for managers to delay the transmission of information to superior managers. For instance if a manager obtains or discovers information (either beneficial or detrimental to the firm), he may delay disclosure of that information to other managers or superior managers in order to secure sufficient time for him to trade on the basis of

¹⁴¹ibid.

¹⁴² Insider trading.

that information before the company acts upon it. Substantial delay would therefore be caused where there are successive trading managers in such a situation.¹⁴³

Where such delays occur, it becomes more likely that outsiders will become aware of the information through snooping or leaks, while others may even independently discover and utilize the information before the company acts upon it. Such delays would definitely be harmful to the company especially because decision making most often requires accurate and timely information, which sometimes must pass through many different levels before reaching a senior manager or a decision maker.

It is also argued that insider trading is harmful to the company because it can lead to interference with corporate plans. Trading during the planning stage of an acquisition is one way in which insider trading can affect corporate plans.

'If the managers are charged with overseeing the acquisition buy shares in the target, the price of the target's shares may rise making the takeover more expensive. Price and volume changes caused by their trading also might tip off others to the secret, interfering with the bidder's plans, as by alerting the target to the need for defensive measures.'¹⁴⁴

Insider trading may create incentives for managers to 'alter firm plans in less drastic ways to increase the likelihood and magnitude of trading profits. For example trading managers can accelerate receipt of revenue, change depreciation strategy, or alter dividend payments in an attempt to affect share prices and insider returns. Alternatively, the insiders may structure corporate transactions to increase the opportunity for secret keeping. Both types of decisions may adversely affect the company and its shareholders.'¹⁴⁵

Despite the foregoing, I am still of the view that the act of trading on insider information can somewhat be justified and its justification should not be considered inconsequential because of the negative popularity it has continued to attract. Some of these views are examined in the next chapter.

¹⁴³Bainbridge S.M: The Law and Economics of Insider Trading: A comprehensive premier 2001 Page 16.

¹⁴⁴Ibid.

¹⁴⁵Bainbridge Op cit Page 17.

PART FOUR

CHAPTER FIVE

5.0 JUSTIFICATION FOR TRADING

5.1 Unfairness - *Equality of Bargaining Position*

The allegation of unfairness will be examined in the context of the *Equality of Bargaining Position*.

According to Lord Denning MR,¹⁴⁶ the concept of fairness is allied to the concept of 'equality.' Equality here implies that as far as possible, parties should have equality of bargaining position, and ascendancy in bargaining position should be allowed only where there are other policy reasons that take prior place. The advocates of the prohibition of insider trading on the ground of unfairness are concerned with the "'fairness' of transactions between insiders and outsiders. They speak against placing insiders ..., ¹⁴⁷ in a better position than outsiders either to make gains or avoid losses in securities transactions."¹⁴⁸

Despite the above argument, I agree with Manne¹⁴⁹ that 'no legislation can ensure equality of bargaining position between those engaged in share transaction with one another. One party will always of necessity have more knowledge about the factors that will affect the share price than another.'¹⁵⁰ In fact, the risk of the other party having more knowledge is an element of every share transaction, "...and neither the company

¹⁴⁶ Lloyds Bank Limited vs. Bundy [1975] QB 326 (CA), [1974] 3 ALL ER 757; See also 'Liability for Failure to Disclose under Rule 10(b) 5' (1968) 20 Stanford LR 347 at 353; HeinOnline -95 S. African L.J.89 1978 Op cit Page 81.

¹⁴⁷ For reasons that have no merit.

¹⁴⁸ HeinOnline -95 S. African L.J.89 1978 Op cit Page 81.

¹⁴⁹ H.G. Manne Op cit Page 7.

¹⁵⁰ HeinOnline -95 S. African L.J.89 1978 Op cit Page 84.

nor any other body should be an insurer against a loss that would result from this unevenness of strength.”¹⁵¹

In an attempt to illustrate the concept of the stock market as an information exchange in which a monetary value is placed on information and where everyone assumes the risk that others will have better information or make better use of it, Manne stated that:

“In many respects, the entire stock market is a complex arrangement for the marketing of information. In an investment market characterized by great risk, a high premium will normally be paid for reliable information.... The different amounts of profit and different individuals will reflect their different degrees of sophistication and the reliability of their information. The stock market is, par excellence, the arbiter of the value of the information.”¹⁵²

5.2 Fraud

Accusing an insider of the crime of fraud is the height of misjudgment. According to *St. Thomas Aquinas*,¹⁵³ fraud can be perpetrated in three ways; either by selling one thing for another or by giving the wrong quality or quantity. *Webster’s New World Dictionary of the American Language*¹⁵⁴ describes it as ‘an intentional deception to cause a person to give up property or some lawful rights.’ It occurs where a person deliberately misrepresents facts to another with the intention that the other will suffer loss or damage upon relying on the misrepresentation.

In the first instance, both the buyer and seller commence a transaction with intent to profit and not with a presumed intention to cause loss or damage to one another. For instance, where a buyer with inside information that the price of stock is likely to increase the next day calls his broker to buy immediately, the fact is that the buyer is

¹⁵¹ HeinOnline –95 S. African L.J.89 1978 Op cit Page 84; J A C Hetherington ‘Insider Trading and the Logic of the Law’ 1967, Wisconsin LR 720 accepts the basic truth of this argument.

¹⁵² H.G. Manne Op cit Page 47.

¹⁵³ G. J. Dalcourt ‘The Philosophy and Writing of St. Thomas Aquinas’ Simon and Schuster/Monarch Press, New York (1965).

¹⁵⁴ College Edition 1964.

not deceiving the seller into selling his stock.¹⁵⁵ Rather, he sells at his own volition being satisfied with the price offered.

Also, since trade of this nature occurs in a free market setting, the buyer does not know who the seller is, and the seller would have sold anyway, anonymously.

'... the average seller has no way in the world of knowing the identity of his buyer. One of the great virtues of an organized securities market is its automaticity, which results in anonymity of traders.'¹⁵⁶

In addition, the seller's action would not have been influenced by the status of the buyer as an insider trader because if the insider trader had not purchased the stock, someone else would have anyway.¹⁵⁷

Consequently, there is no loss or damage to one another. Even where there is a record of loss, the mental element of ill intention and the physical element of misrepresentation and deception resulting in loss to the recipient(s) must be proved for a person to be guilty of the crime of fraud. In the absence of this, there should be no correlation between insider trading and fraud.

5.3 Fiduciary Responsibility

Where a fiduciary relationship exists; the fiduciary must exercise his powers for the benefit of the other party who may be the principal, the shareholders or the Company. It would be tantamount to illegality if the fiduciary does otherwise.

However, it is important to know that 'fiduciary responsibilities do not exist in vacuum.'¹⁵⁸ A person does not stand in a fiduciary relationship merely because he is a businessperson. Rather there must be a conscious recognition and voluntary acceptance of the relationship. Therefore, an insider trader by virtue of this status alone does not stand in a fiduciary relationship with an 'outsider.' 'It would be the rare stock market deal indeed where the insider happened to be related in this manner to the relevant outsider. And even if such a rare occurrence did come to pass, it could hardly

¹⁵⁵ Robert W. McGee, Walter E. Block Op cit Page 6.

¹⁵⁶ H. G Manne: In Defense of Insider Trading.' (1966) 44 Harvard Business Review Page 114.

¹⁵⁷ Ibid.

¹⁵⁸ Robert W. McGee, Walter E. Block Op cit Page 18.

be considered violation of fiduciary responsibilities; rather, it would be deemed as the merest of coincidence.¹⁵⁹

5.4 Degree of damage

A major reason for the prohibition of insider trading is the supposed damage caused to the investing public. Conversely, supporters of the act have argued that there is no proof that damage is caused by insider trading.¹⁶⁰ According to *Manne*, only an extremely small fraction of the total outstanding shares is being traded.¹⁶¹ Thus, the extent of the evil attributed to insiders, in relation to the market for shares, will usually be negligible, because insider trading will influence prices in only a small proportion of cases. In addition, 'shareholders who do not trade will not be harmed, since by holding on, they will benefit ultimately from the increased value of the shares. The only parties that will be harmed at all are those who traded just prior to a release of information that would have affected the prices when insiders were active in the market.'¹⁶²

Manne further argued that:

'the only way parties can lose is where they sell at a time when the market price is lower than it would have been were the full facts known in which case the amount lost by these sellers is the difference between the market price they receive and the price they would have received had the good news been known. If the price had begun to rise before the public disclosure, the amount of loss would be reduced to the extent that the price had risen at the time they sold. This would be true when insiders are trading.'¹⁶³

Holding the view of *Manne*, *Professor Hetherington*,¹⁶⁴ pointed out that there are two classes of outsiders who may in fact suffer harm. The first class is those who sold with the impression that the market was advantageous and not for any personal or other reasons unrelated to price. The second class is those who would not have sold if they

¹⁵⁹ Robert W. McGee, Walter E. Block Op cit Page 30.

¹⁶⁰ H.G Manne Op cit Page 98.

¹⁶¹ On the average, 0.27 per cent of the listed shares in any week.

¹⁶² HeinOnline -95 S. African L.J.89 1978 Op cit Page 84.

¹⁶³ HeinOnline -95 S. African L.J.89 1978 Op cit Page 85.

¹⁶⁴ 'Insider Trading and the Logic of the Law' 1967, Wisconsin LR 720 at 723.

had known what the insiders knew. For the former class,¹⁶⁵ the damage is not attributable to insiders¹⁶⁶ while in the latter class, 'the lost profit stems from the fact that because the good news was not generally known, the price had not risen hence, the loss is caused because the outsider picked the wrong time to sell.'¹⁶⁷

Professor Hetherington also agreed with *Manne* that the 'situations in which the outsider is harmed are *improbable*'¹⁶⁸ and the absolute odds in favor of his [outsider's] losing anything as a result of insider trading are so small as to be unworthy of anything of serious concern.¹⁶⁹ In other words, no specific injury is caused to investors in general. A good example may be seen '...in a stock exchange situation where there is a sale by an outsider, the offer by the insider would ordinarily be close to the market price.' In the case of a transaction not on the stock exchange, the same considerations would apply in the absence of any misrepresentation or other inducement to trade.'¹⁷⁰

As a matter of fact, any deviation from the market price would accrue to the benefit of the outsider, since, to complete the transaction, the insider's offer would have to have beaten the offers of others or at least have been the same as the highest of them. In the same vein, an insider may also be willing to trade at a higher price than the current market price for the reason that he expects an increase in the value of the shares.¹⁷¹

5.5 Manipulation

It is argued that if insiders are allowed to trade freely, they will manipulate the affairs of the corporation by maximizing their own trading profits rather than the company's earnings. In the United States of America for instance, an investigation by the Senate Committee on Banking and Currency from 1932 to 1934 revealed that insiders often attempted to unsettle the market.¹⁷²

¹⁶⁵ That is those who under the notion that the market price will rise.

¹⁶⁶ Except the activities of the insiders, cause the price rise.

¹⁶⁷ HeinOnline -95 S. African L.J.89 1978 Op cit Page 85.

¹⁶⁸ Ibid.

¹⁶⁹ H.G. Manne Op cit Page 110. See also HeinOnline -95 S. African L.J.89 1978 Op cit Page 85.

¹⁷⁰ HeinOnline -95 S. African L.J.89 1978 Op cit Page 85

¹⁷¹ HeinOnline -95 S. African L.J.89 1978 Op cit Page 85-86

¹⁷² HeinOnline -95 S. African L.J.89 1978 Op cit Page 91.

According to Manne,¹⁷³ insider trading poses no danger of manipulation. On one hand, 'much information determines its own release date such that insiders are often unable to affect disclosure date e.g., the date of a dividend declaration, an announcement of a development extraneous to the company, or tax returns.¹⁷⁴ On the other hand, there are frequently no incentives to affect these dates because of the many techniques available for exploiting information quickly.'¹⁷⁵

"There are few incentives for manipulation of stock prices that conflict with the long-run interests of the corporation and its shareholders.' '... Manipulation which takes the form only of changing the time at which disclosure is made is of no consequence to all outsider investors considered as a group.'¹⁷⁶

In addition to the foregoing, Manne argues that 'the grosser forms of manipulation can be dealt with effectively through less drastic techniques than preventing insider trading.'¹⁷⁷

5.6 Effect on Long Term Investors

The prohibition of insider trading does not deter persons who plan to hold shares in the long term.

This is because the long-term shareholders

'... tend to select stocks based on so-called *fundamental* factors such as earning potential, dividend history, growth prospects, or the reputation of management, to mention just a few. And they select stocks suitable for their own particular investment needs. They tend to sell either because their estimate of the fundamental factors proved wrong or because of some change in their personal circumstances or needs. They almost never buy or sell because of short-swing fluctuations in the price of a security.'¹⁷⁸

If we therefore '...limit our concerns to the long term investor rather than the short-swing traders, there is little likelihood for injury from insider trading.'¹⁷⁹

¹⁷³ Of whose view I support.

¹⁷⁴ H.G. Manne: In Defense of Insider Trading page 105.

¹⁷⁵ Ibid.

¹⁷⁶ H. G. Manne: In Defense of Insider Trading page 119.

¹⁷⁷ Ibid.

¹⁷⁸ H. G. Manne: In Defense of Insider Trading page 114.

¹⁷⁹ H. G. Manne: In Defense of Insider Trading page 113.

Moreover, the long term investor may even benefit from insider trading where he is the seller as the average price received may be higher with than without insider trading.¹⁸⁰

For example:

‘Let us assume that a stock is selling at fifty dollars, with undisclosed good news which will *ultimately* cause the stock to sell for sixty dollars, and that no factors other than the good news will affect the price.

Suppose, further, that with insider trading the price of the shares rises *gradually* to sixty dollars. The average price at which shares sell during this period is somewhere in the neighborhood of fifty-five dollars (more or less depending on the shape of the time-price curve). At sixty dollars, anyone who has held his shares will have received the full benefit of the new information whether it is disclosed to him or not. This advantage to the ultimate holder remains even if we effectively prevent insider trading.

Without insider trading, however, the position of those who sell during the time required for the price to rise from fifty dollars to sixty dollars is radically altered. No longer do they receive an average price of fifty five dollars. Assuming that the ultimate disclosure is made at the same time under either rule, they receive only fifty dollars for their shares without insider trading. In short, they get less than they would with insider trading.’¹⁸¹

5.7 Moral and Fiduciary Duty of Disclosure

As earlier discussed,¹⁸² the scope of the fiduciary duty of disclosure has been clearly established by the U. S. Supreme Court rulings in *Chiarella vs. United States* and *Dirks vs. SEC*.

In *Chiarella's* case,¹⁸³ Chiarella was an employee of a printing Company. Part of his job was to print confidential documents for corporations. In the course of his employment, he was able to determine that certain companies were going to be the target of takeovers and he bought stock in those companies. He did not have a fiduciary relationship to the company's stockholders. The Supreme Court held that he was not guilty of violating rule 10b-5 because he did not commit any fraud against the party who

¹⁸⁰ H. G Manne: In Defense of Insider Trading page 119: See also HeinOnline –95 S. African L.J.89 1978 Op cit Page 98.

¹⁸¹ H. G Manne: In Defense of Insider Trading page 115.

¹⁸² See Page 10 of Chapter two.

¹⁸³ 445 U.S. 222 ,228 (1980) at 234-35.

sold him the stock. According to the Supreme Court, 'one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.'¹⁸⁴

Similarly, in *Taylor vs. First Union Corp. of So. Carolina*, the First Circuit Court of Appeals held that a corporation has no duty to disclose tentative merger plans to stockholders before it buys their stock.¹⁸⁵ Hence, those in possession of non-public information do not have a general duty to disclose the information to the marketplace.¹⁸⁶

I align my thoughts with that of *St. Thomas Aquinas* that there is no moral duty to inform a potential buyer that the price of goods one is trying to sell is likely to change in the near future.¹⁸⁷ In the absence of such moral duty of disclosure, certainly there should be no legal duty either.¹⁸⁸

Aquinas gave an illustration of a wheat merchant who:

carries wheat to a place where wheat fetches a high price, knowing that many will come after him carrying wheat;... if the buyers knew this they would give a lower price. But ... the seller need not give the buyer this information....[T]he seller, since he sells his goods at the price actually offered him, does not seem to act contrary to justice through not stating what is going to happen. If however he were to do so, or if he lowered his price, it would be exceedingly virtuous on his part; although he does not seem to be bound to do this as a debt of justice.¹⁸⁹

Another illustration was discussed by *Cicero*¹⁹⁰ where a grain merchant is bringing grain from Alexandria to Rhodes. He is aware that the inhabitants of Rhodes are in need of grains and that other grain merchants will soon arrive. Nevertheless, if he discloses this fact to them, it will reduce the price of his grain.¹⁹¹ On whether he would disclose this information, the merchant had this to say:

¹⁸⁴ *Chiarella vs. United States*.

¹⁸⁵ 857 F. 2d 240 (4th Cir. 1988).

¹⁸⁶ See also Macy, *The SEC's Insider Trading Proposal*.

¹⁸⁷ *SUMMA THEOLOGICA* Pf 11-11, Q.77 Art. 3, Obj. 4 (Fathers of the English Dominican Province trans. 1947).

¹⁸⁸ Robert W. McGee, Walter E. Block Op cit Page 6.

¹⁸⁹ *SUMMA THEOLOGICA* Op cit Obj. 4, Reply Obj 4.

¹⁹⁰ *The Offices Book*. III, ch. xiii (E. Rhys ed. 1990).

¹⁹¹ Robert W. McGee, Walter E. Block Op cit Page 7.

'it is one thing to conceal... not to reveal is quite a different thing. At this present moment, I am not concealing from you, even if I am not revealing to you... and to know these secrets would be of more advantage to you.... But I am under no obligation to tell you everything that it may be to your interest to be told.'¹⁹²

The wheat and grain merchants in the preceding illustrations may be likened to insiders who are privy to confidential information that is not generally available to the public and who does not have a moral duty to disclose it.

5.8 Adequate Compensation

Employees are being accused of earning more than their regular salary package and in that way cheat their employers. Critics of insider trading on this ground merely focus on the effect of the act on the insiders' employer and not 'the public interest.' This is rather limiting.¹⁹³ Even where the insider employee is guilty of the charge, it seems more appropriate to classify the offence as a breach of an 'employment contract'¹⁹⁴ rather than a breach of the legislation. An employment contract amongst others details the rules and regulations that govern employment relationship and requisite penalties for its breach. I am of the opinion that it is unnecessary to subject all corporate organizations to the dictates of legislation when employment contracts deal with specific issues affecting the corporation. Moreover, not all corporate organizations condemn the practice of insider trading.¹⁹⁵

In addition to the foregoing, I agree with *Manne*¹⁹⁶ that to use inside information in trading is the one appropriate and adequate way to compensate the entrepreneur.¹⁹⁷ In an attempt to compare the skill of a 'manager' with that of an entrepreneur, Manne asserts that a manager does not innovate; instead, his skill is primarily a 'learnable' mechanical ability such that his next move is predictable. An entrepreneur on the other

¹⁹² Lawson's discussion on the passage from Cicero: The Ethics of Insider Trading, 11 Harv. J.L. & Pub. 738-39 (1988).

¹⁹³ HeinOnline -95 S. African L.J.89 1978 Op cit Page 31.

¹⁹⁴ Employment Contract as an alternative to the regulation will be discussed extensively in the next chapter.

¹⁹⁵ H.G. Manne Op cit (1996).

¹⁹⁶ W Painter: 'Manne, Insider Trading and the Stock Market' (1967).

¹⁹⁷ In this context an, 'inside trader.'

hand is highly innovative. He does not perform tasks that are conventional. His function is to make new combinations of productive factors to bring them together in a new way. The only appropriate manner of compensating such an inventive entrepreneur for his entrepreneurial activities is by an 'unfettered insider trading' as '...even the most bureaucratically minded persons may begin to have original ideas if the possibility of large rewards is apparent' otherwise, he ¹⁹⁸ '...will tend to disappear from the corporate scene.'¹⁹⁹

5.9 Influence on Stock Market and Price Regulation Trend

An effective stock market is one that best serves the interest of investors and insider trading facilitates efficiency at the market. When insiders make use of their knowledge based on special information by buying when share prices are declining without good cause and selling when prices are artificially high, there is a resultant effect of 'continuity in the prices of shares'²⁰⁰ and 'a gradual escalation or de-escalation of prices.'²⁰¹ Without insider trading, 'the direction and magnitude of price changes in shares would always be uncertain and there would be no discernible dependence of one transaction price on the immediate preceding price.'²⁰² The only thing that can guarantee dependence of one transaction on another is knowledge. That is information or 'knowledge of specific facts'²⁰³ of the company's affair or of conditions in the industry concerned which might also affect prices.

Manne in his analogy divided all traders into those who have reliable information, by virtue of being insiders, and the 'know-nothings' who do not have any information. His conclusion was that 'those who have reliable information will buy as much as they can as long as the market price is below the level to which it can be expected to rise on publication of the information while the others will act according to price or time or a

¹⁹⁸ H.G. Manne Op cit Page 123.

¹⁹⁹ Ibid.

²⁰⁰ HeinOnline -95 S. African L.J.89 1978 Op cit Page 93.

²⁰¹ H.G. Manne: 100.

²⁰² HeinOnline -95 S. African L.J.89 1978 Op cit Page 93.

²⁰³ H.G. Manne Op cit (1996).

combination of both. The 'know-nothings' will end up not influencing share price movement and will cancel one another out.²⁰⁴

Still on the effect of insider trading on the stock market, Manne also argued that:

'transactions based on insider information draw other transactions towards them, and that formerly random transactions are drawn towards correct levels. This occurs because outside sellers will sell to the insider when the price offered is more than the price outside buyers is offering. And as transactions are a function of price, some outside buyers and sellers will now buy from and sell to each other at a higher price. outsiders who did not purchase shares, but who would have done so had they known the facts, are not damaged, because, had they known them, the price would probably have risen before they could have acted upon the knowledge, and it would no longer have had any value.'²⁰⁵

²⁰⁴ HeinOnline --95 S. African L.J.89 1978 Op cit Page 94.

²⁰⁵ Ibid. This argument has been opposed on the ground that Manne failed to provide empirical data. It has also been argued that although available evidence suggests that insiders may influence the market but they do not determine trends, save in the most exceptional circumstances.

PART FIVE

6.0 CHALLENGES TO INSIDER TRADING REGULATION

There have been various challenges to insider trading regulation. For the purpose of this study, two of the challenges will be discussed.

6.1 Proof of insider trading

The ability to prove that the 'offence' was actually committed remains a major challenge for the prosecution of insider trading.

The first issue is the absence of witnesses. Generally, the input of professional advisers such as brokers, bankers and lawyers is crucial to the prosecution process especially where they assist in the investigations of insider trading. However, it is difficult to find expert witnesses to help establish that the information used was price sensitive. Regulators often hold the view that they²⁰⁶ are uncooperative, because of the natural caution to protect their clients. In return, they expect professionals to be forthcoming and assist in investigations. In reality however, different professional groups have different perceptions on this issue. Closely connected to this is the fear of losing a client. Individuals and corporate bodies are usually reluctant to give evidence because of the fear that their clientele list may drop.

Secondly, there is the problem of establishing that the information available to the trader was indeed 'price sensitive.' That is to say, the information was likely material to affect the price of the security. The looseness of this requirement is a serious defect in current legislation generally and research has shown that it is necessary to spell out more precisely what 'likely material to affect the price' means. As earlier stated, the interpretation and application of materiality is quiet ambiguous and attempts to clearly define the concept have failed partially because the task is too fact-dependent.²⁰⁷ This requirement has made it very difficult for effective prosecution of the act.

²⁰⁶ The regulators.

²⁰⁷ Joan MacLeod Heminway Op cit Page 1150.

Another significant difficulty is the criminal nature attributed to insider trading which results in a standard of proof that is beyond reasonable doubt. Some regulators believe that if the standard of proof is lower, its prosecution would become easier, but many hold a contrary opinion.²⁰⁸ If a civil standard of proof on the balance of probabilities is introduced, many regulators fear that the sanction of imprisonment would be abandoned. This is however inadvisable because the principal deterrent that proponents of the regulation seek would have been aborted. A number of regulators added that even if a civil standard of proof replaces the current standard, there would still be the need to obtain evidence and prove the elements of insider trading on the balance of probability.²⁰⁹

At this point, regulators are caught in between two worlds. It has been suggested that rather than lowering the standard of proof, a more effective strategy might be to reverse the onus of proof, to require the accused to prove that his or her conduct does not fall within the terms of the Act for this seems the only realistic solution void of a significant redrafting and simplification of the current legislative provisions. Some regulators have even gone to the extent of submitting that the judiciary lacks a grasp of the nature of market realities in this area, hence a need to educate them accordingly.²¹⁰

²⁰⁸ Australian Studies in Law, Crime and Justice. 'The Prosecution of Insider Trading: Obstacle to Enforcement.' Published in Casino Capitalism, Insider Trading in Australia (internet sourced).

²⁰⁹ Ibid.

²¹⁰ Ibid.

6.2 Punishment/Enforcement

The quantum of punishment imposed on an insider trader as well as the enforcement of the legislation has continued to constitute a major challenge to the regulation of insider trading.

Sections 10 (b), 14 (e) and 21 (a)²¹¹ provides respectively:

10(b) *It shall be unlawful for any person... to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.*

14(e) *It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices.... The Commission shall... prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.*

21 (A) **Judicial Actions by Commission Authorized**

Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder ..., the Commission—

- A. *may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by the person who committed such violation; and*
- B. *may, subject to subsection (b)(1) of this section, bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by a person who, at the time of the violation, directly or indirectly controlled the person who committed such violation.*

²¹¹ SEC 1934.

2. Amount of penalty for person who committed violation

The amount of the penalty which may be imposed on the person who committed such violation shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication.

3. Amount of penalty for controlling person

The amount of the penalty which may be imposed on any person who, at the time of the violation, directly or indirectly controlled the person who committed such violation...shall not exceed the greater of \$1,000,000, or three times the amount of the profit gained or loss avoided as a result of such controlled person's violation.

These provisions give the SEC the authority to seek a court order requiring violators to give back their trading profits. The SEC can also ask the court to impose a penalty of up to three times the profit the violators realized from their insider trading.

In addition to the financial penalties, there are criminal penalties, which have undergone a series of amendments and re-codification. The Insider Trading Sanction Act²¹² increased the criminal penalties from a maximum fine of \$10,000 to \$100,000. Also, by the Insider Trading and Securities Fraud Enforcement Act,²¹³ there was a further increase on the maximum criminal fines from \$100,000 to \$1,000,000 for a natural person and \$2,500,000 fine on any person other than a natural person who violates the provisions of the law in this regard. Similarly, the maximum prison sentence was increased from five to ten years.

In addition, Section 32(a) of the SEC as amended by Section 1106 of the Sarbanes-Oxley Act of 2002 states that,

²¹² 1984.

²¹³ 1988.

'Any person who willfully violates any provision ... shall upon conviction be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding \$25,000,000 may be imposed'

Overtime, efforts have been made to tighten the penalty provisions of the various legislations on insider trading such that more and more penalties are being imposed. Even with this increase, the proponents of insider trading regulations are still of the view that the penalties are not adequate, thereby working to increase them more. A bill in the US Senate, for instance, seeks to make insider trading a felony punishable by up to 10 years in prison.

Though there have been strict anti-insider trading laws in the United States of America since 1934 at least, in a study conducted on what an insider will do with unpublished price sensitive information,²¹⁴ of some 1700 corporate executives asked; 42 per cent said that they would trade personally on the information; 14 per cent said they would give the information to a friend; only 2 per cent said they would tell their brokers. In a further study on what the executives thought other company executives would do in such situation, 61 per cent thought other executives would use the information for trading; 46 per cent thought other executives would pass it on to a friend while just 11 per cent thought other executives would tell their stockbrokers.

Similarly, the Italian legal system has also experienced great difficulty in punishing illegal insider trading. In view of the fact that they were first enacted in 1991, the Italian insider trading rules have led to very few convictions with a very low ratio of prosecutions of allegations of illegal trading. Moreover, leakage of private information appears to be widely spread, given that news about firm-specific events seems to be incorporated in stock prices long before it is disclosed in public announcements.²¹⁵

²¹⁴ By Reverend R C Baumhart in 'How Ethical Are Businessmen?' (1963) 39 Harvard Business Review 6.

²¹⁵ The effectiveness of Insider Trading Regulation in Italy. Evidence from Stock-Price Run ups Around Announcements of Corporate Control Transaction; Page 199-218.

PART SIX

7.0 CONCLUSION

At the beginning of this study, I set out some research questions that would be addressed during the course of the study. These were:

- i. Who is an insider trader and what is the nature of inside information?
- ii. To what extent does the common law and equity curb the activities of insiders and is statutory intervention more effective?
- iii. What are the 'disadvantages' of trading on inside information?
- iv. What are the bases for justifying insider trading? Are these reasons cogent enough to allow it?

The first and second research questions as listed above were addressed in chapters two and three of this study.

In answering the third research question as stated above, I examined the ills/disadvantages of insider trading as submitted by the proponents of its outright prohibition in chapter four of this study. According to some of their arguments, insider trading amounts to breach of trust by a corporate insider. It is an unfair practice whereby some become wealthy with little (visible) efforts, others do not. Also, insider trading is harmful to the company as it injures the company's reputation.

Despite these arguments, I maintained the view that insider trading is justifiable. Some of the reasons for its justification were examined in chapter five.

In my attempt to address the last research question, I commenced chapter five by examining the allegation that insider trading is unfair in the context of the *Equality of Bargaining Position*. I supported the view of Manne that in every share transaction, one party will always of necessity have more knowledge about the factors that will affect the

share price than the other.²¹⁶ In fact, the risk of the other party having more knowledge is an element of every share transaction.

Furthermore, I argued that insider is not a fraudulent act. Since fraud occurs where a person deliberately misrepresents facts to another with the intention that the other will suffer loss or damage upon relying on the misrepresentation, accusing an insider of the crime of fraud is the height of misjudgment. This is because with insider trading, both the buyer and seller commence the transaction with intent to profit and not with a presumed intention to cause loss or damage to one another.

I supported the contention of Manne that if the concern of the advocates of the prohibition of insider trading is limited to only the long term investors rather than the short-swing traders, there is little likelihood for injury from insider trading for the reason that the long term investors are less likely to sell as a result of price changes effected by insiders, and sell because of changed financial circumstances or death. And, '...the less frequently the outsider trades, the less he will lose from exploitation of material information by insiders.'²¹⁷

As established by the U. S. Supreme Court rulings in *Chiarella vs. United States* that one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so, I argued that those in possession of non-public information truly do not have a general duty to disclose the information to the marketplace.²¹⁸ Also, I aligned my thoughts with that of *St. Thomas Aquinas* that there is no moral duty to inform a potential buyer that the price of goods one is trying to sell is likely to change in the near future²¹⁹ and, in the absence of such moral duty, there is certainly no legal duty either.²²⁰

²¹⁶ HeinOnline –95 S. African L.J.89 1978 Op cit Page 84.

²¹⁷ HeinOnline –95 S. African L.J.89 1978 Op cit Page 98.

²¹⁸ The First Circuit Court of Appeals decision in *Taylor vs. First Union Corp. of So. Carolina*, 857 F. 2d 240 (4th Cir. 1988). See also Macy, *The SEC's Insider Trading Proposal*.

²¹⁹ SUMMA THEOLOGICA Pf 11-11, Q.77 Art. 3, Obj. 4 (Fathers of the English Dominican Province trans. 1947).

²²⁰ Robert W. McGee, *Walter E. Block Op cit Page 6*.

A strong submission against insider trading is the fact that insider employees earn more than their regular pay packet thereby cheating their employers. I was of the opinion that this submission merely focuses on the effect of insider trading on the insiders' employer and not 'the public interest.' Even where the insider employees are guilty of the charge, it seems more appropriate to classify the offence as a breach of an 'employment contract' rather than a breach of insider trading regulation. Furthermore, I agreed with *Manne*²²¹ that to use inside information in trading is the one appropriate and adequate way to compensate an entrepreneur for his entrepreneurial activities.

Lastly, I argued that insider trading facilitates efficiency of the stock market. With insider trading, there is 'continuity in the prices of shares'²²² and 'a gradual escalation or de-escalation of prices.'²²³ However, without insider trading, 'the direction and magnitude of price changes in shares would always be uncertain and there would be no discernible dependence of one transaction price on the immediate preceding price.'²²⁴

Finally in this chapter, I considered two major challenges to insider trading which was proof that the '*offence*' of insider trading was actually committed and the quantum of punishment imposed on an insider trader as well as the enforcement of the insider trading legislation.

In the light of the above arguments, I am of the strong opinion that insider trading should not be outlawed.

²²¹ W Painter: 'Manne, Insider Trading and the Stock Market' (1967).

²²² HeinOnline -95 S. African L.J.89 1978 Op cit Page 93.

²²³ H.G. Manne: 100.

²²⁴ HeinOnline -95 S. African L.J.89 1978 Op cit Page 93.

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