THE COMPANIES AMENDMENT ACT, 1989

A PANACEA FOR INSIDER TRADING?

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

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SEPTEMBER 1990

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1. INTRODUCTION

"... Our enquiries suggest that a large ring of people have dealt at the stock exchange using information (whether they have in all cases known it or not) which has ultimately derived from one particular Crown servant. The scale of the dealings in that ring is such that the value of the shares bought and sold by its members comfortably exceeds 10 million pounds. Our enquiries have also suggested, however, that there may well have been more than one Crown servant involved in disseminating unpublished price-sensitive information and that, rather than there being one ring, there has been a second ring as well, not necessarily connected with the first.

...It is, in our view, inevitable that criminal activity relating to insider dealing will flourish if those carrying out such activities are effectively assured of anonymity and comforted by the fact that enquiries such as ours can be impeded in this all-important area. In particular, we consider the evidence relating to the very scale of the activities and the number of persons involved to be indicative of the attractions of insider dealing and it is inevitable that those concerned will continue these activities unless checked by being identified, prosecuted and, if found guilty punished". (1)

1.1. THE NATURE OF INSIDER TRADING

Insider trading is commonly understood to cover situations where a person buys or sells securities when he, but not the other party to the transaction is in possession of confidential information which affects the value to be placed on those securities.

This type of information is only obtainable by persons with an intimate relationship towards the company such as its directors, employees, professional advisors or state functionaries concerned with the regulation of its activities, and insider trading hence occurs when such persons actually use, or pass on to others who use, such information upon which to trade for personal gain.

As illustrated in the example cited above, the major problem in detecting violations of this kind is that since they are usually conducted in absolute secrecy, one never knows just how frequently or infrequently insider trading occurs.

It has been said (2) that the insider trading cases hallmark is complete silence and this, taken together with the concomitant feature that trading most often takes place over anonymous markets such as the stock exchange, has the result that investors and shareholders, including those who sold to or bought from the insider, knew nothing of the true state of affairs.

(1) Re an inquiry under the Companies Securities (Insider Dealing) Act 1985 (1988) I All ER 203 (HL) at 210j -211f.

(2) Branson, D.M.; Insider Trading - I: The British Regulation in the Light of the American Experience; Journal of Business Law 1982/83 p. 342 at p. 343.

Consequently, the authorities have to monitor any undue movement in the price or volume of trading in a listed security as this is generally the only way of discovering whether insider trading is taking place.

1.2. CONSIDERATIONS OF PUBLIC POLICY

The fact of the matter is that insider trading does occur. Cases such as the inquiry into conduct of The Times financial journalist Jeremy Warner, the subject of the decision mentioned above, and the more recent Drexel junk bond fiasco in the United States highlight its magnitude and import.

The question whether or not the law should regulate the activities of a trader who deals in securities whilst in the possession of inside information can only be decided after a careful weighing of considerations of public policy.

A decision in this regard is fundamental as not only will it affect any prohibition, but it will also influence the method of its regulation and the remedies given to persons affected by its contravention.

The justification for the prescription of the practice at all has been hotly debated, but a number of reasons and principles, accepted as determinants of social policy and regulation have been identified (3) as requiring, or at least pointing in favour of, the curbing of abusive insider trading.

(a) The concept of fairness and equity maintains that it should not be permissible that the gain or loss from a security transaction be governed by the access of one of the parties to inside information;

(b) The effect of insider trading on corporate management is deleterious;

(c) Insider trading is likely to have an adverse effect on confidence in the securities markets of a country as an efficient and honest allocator of scarce capital resources, both domestically and internationally. Investors will accordingly be deterred from participating in the stock market;

(d) Unrestricted insider trading could materially damage the company as a whole by impugning its reputation of integrity and its image of probity essential to its ability to raise capital; and

(e) In a capitalist economic system where general prosperity is tied to the prosperity of individual companies, it is important to eliminate practices that cause companies harm.

As with any form of legislative intervention, it is for the State, its advisors and law makers, as a reflection of the needs of their people, to decide whether, and if so, in what form, the practice of insider trading is to be regulated.

(3) Pfrench, H.L.; Rider B.A.K; Should Insider Trading Be Regulated? Some Initial Considerations; (1978) 95 SALJ 79.

2. THE PRE-AMENDMENT POSITION

If it can be said that the propensity for insider trading is, initially at least, a function of economic activity, then its history in South Africa can be little different to that anywhere else in the world.

Paul Kruger called Johannesburg "the Devil's City" and said that the stock market was established because "share gambling in street and saloon was getting out of hand". (4) In the intervening years not much seemed to alter as the Johannesburg Stock Exchange was described as a "casino" and "cattle auction" during the 1960's. (5)

Perhaps it was these undertones which necessitated the urgent attention of the Van Wyk de Vries Commission. Indeed, a startling aspect of its Report in 1970 was not the unanimous condemnation of insider dealing by all the witnesses who appeared before it, (6) but the fact that the existence of the practice appears never to have been in doubt.

Against this backdrop, it was abundantly clear that the law in this regard needed to be closely examined.

2.1. THE COMMON LAW

The Law of Contract has always provided some measure of relief to aggrieved parties:

In the case of a purchaser of securities, aedilitian relief may be sought against a seller with inside information on the basis of a latent defect or a misrepresentation, whether fraudulent or innocent, which amounts to a *dictum et promissium.* (7)

It has further been recognised (8) that where directors approach persons asking them to subscribe in the securities of the issuer, any adverse inside information which they possess is similar to a knowledge of a latent defect possessed exclusively by the seller of goods, and accordingly the purchaser is entitled to expect the disclosure of all material information.

In such instances, the buyer may seek relief in the form of restitution or a reduction in the purchase price of the securities.

(4) Jenkins, A. The Stock Exchange Story (1973) 102.

(5) Stock Exchange Journal (U.K.) September 1971 p.12.

(6) Main Report of the Commission of Enquiry into the Companies Act RP 45/1970. Paragraph 44.49.

(7) Phame (Pty) Ltd vs Paizes 1973 (3) SA 397 (A).

(8) Pretorius and Another vs Natal South Sea Investment Trust Ltd. (Under Judicial Management). 1965 (3) SA 410 (W).

In the case of a seller of securities, our common law has been less inclined to afford relief. Where securities are sold to a buyer who purchases them on the basis of confidential inside information, which when made public will cause their value to increase, the courts have not allowed a remedy, holding that there is no general duty of disclosure.(9)

On the strength of certain authorities (10) however, such a duty may arise where one party is aware of the other party's ignorance of facts within the former's knowledge or must know of it because the facts are accessible only to himself. (11)

It was held in Percival vs Wright (12) that a director who purchased securities from a shareholder of his company on the strength undisclosed price-sensitive information was under no duty to pass on that special inside knowledge of corporate affairs.

Although certain Commonwealth decisions (13) were successfully able to find distinctions, a seller aggrieved by insider trading on the part of a director was not assured of a remedy at common law. Due further to the paucity of cases of this nature which came before our courts for decision, coupled with tenuousness of evidence often available (14), the judiciary appears destined to be rendered impotent in curbing such practices.

In the case of listed shares, the clearing house methods adopted by brokers for securities traded on the Johannesburg stock exchange had the effect of masking the identities of both buyer and seller thus further binding the hands of an aggrieved party.

2.2. THE COMPANIES ACT 61 OF 1973

The failure of our common law to develop an effective means of addressing the abuse of insider trading made it abundantly clear that legislative intervention would be necessary.

As a result, the Van Wyk de Vries Commission was particularly concerned with the problem of how to regulate insider trading and took a considerable amount of evidence both from within the Republic and abroad. (15)

After due deliberation the Commission, on the accepted premises that insider abuse is prevalent and that this has an adverse effect on the confidence of the public in dealing in securities, recommended that insider trading should be made a criminal offence, carrying heavy penalties. Owing to the difficulty of establishing privity it rejected the notion of civil liability, although the view was expressed that where there had been a criminal conviction the person who had dealt with the insider would be able to have the transaction set aside. (16)

(9) Gibson, J.T.R., South African Mercantile and company Law; 6th Edition p. 421.

(10) Speight vs Glass and Another 1961 (1) SA 778 (D); Refco Ltd vs Amicor Investments 1964 (3) SA 184 (FC).

(11) Gibson, J.T.R., op cit p. 421.

(12) [1902] 2 Ch. 421.

(13) Allen v Hyatt (1914) 30 TLR 444; Coleman vs Meyers [1977] 2 NZLR 225.

(14) Sage Holdings Ltd vs The Unisec Group Ltd and Others 1982(1) SA 337 (W) at 367H.

(15) Rider, B.A.K.; The Regulation of Insider Trading in the Republic of South Africa. (1977) 94 SALJ 437.

(16) Rider, B.A.K.; op cit p. 439 - 440.

The policy basis adopted by the Commission in making recommendations focusing on the criminalisation of insider trading appears clearly to have been one founded in notions of the impropriety and dishonesty of the practice.

A Supplementary Report and a Draft Bill were also submitted to the Government by the Commission and its recommendations in relation to insider trading were substantially implemented, resulting in the enactment of **Sections 229 to 233 of the original 1973 Act.**

The core anti-insider trading provision is **Section 233** which makes it an offence for:

"Every director, past director, officer or person who has knowledge of any information of the company or of the affairs of the company which if it becomes known may be expected to materially affect the price of the shares or debentures of the company, to deal in any way to his advantage, directly or indirectly, in such shares or debentures while such information had not been publicly announced on a stock exchange or in a newspaper or through the medium of the radio or television."

A striking feature of the provision is the rather narrow ambit given to the concept of an insider. The definitions in **Section 229** only slightly widen the net of persons capable of being held liable, but for instance, a fairly senior employee who has no immediate relationship with the directors would not be precluded from dealing to his advantage in securities of the company.

In addition, liability for insider trading does not extend to "tippees" or secondary insiders such as those with no immediate relationship to the company whose shares and debentures are dealt, or to persons such as those who give the company professional advice.

For the information to be affected by the prohibition it must concern a transaction or proposed transaction of the company or of the affairs of the company which, if it becomes publicly known may be expected to materially affect the price of the shares or debentures of the company.

The legislation in this regard is sufficiently wide to cover the whole field of the company's operations, but this is tempered by the concept of materiality so that matters of general knowledge such as trends in the business, the buoyancy of the market and other economic factors are irrelevant.

It has however been pointed out (17) that the section does not indicate whether the test is to be an objective or subjective evaluation.

Once both an insider and inside information have been established by the formula laid down in the Act, it must be proved that the insider with knowledge of the inside information actually dealt to his advantage before such information was made public.

Again, problems were foreseen. What standard will be applied in determining knowledge is a matter for pure speculation, although, as in other countries, it is likely that intention or possibly recklessness will be required. (18) Due to the fact that not a single prosecution has ever been instituted, the interpretation of this aspect of the **1973 Act** by the courts is destined never to come to light.

(17) Ibid, p. 444.

(18) Ibid, p. 444.

The wording of the prohibition in respect of the dealing is wide enough to encompass situations as diverse as the use of nominees, spouses or children in attempts to cloud what is in reality an insider deal. However, where the insider deals on the behalf of a person whose personal fortunes are in no way connected with those of the insider, there can be no question of liability, unless there is some evidence of a "mutual backscratching" arrangement. (19)

The question of the degree of publicity to be accorded to the inside information has also been vexed. As no stipulation is placed on the degree of dissemination, the crucial factor being the announcement, there would seem to be nothing to prevent, for example, the information being disclosed at 23h30 on the Zulu programme for outlying townships. Similarly, there would seem to be a sufficient disclosure if the information were published in some extremely small local newspaper nowhere near the financial centres. Of course, it could be argued that the words "publicly announced" impart at least a means of communication that is likely to be received by a significant number of interested persons, but it is to be doubted whether on a proper examination this construction would stand up. (20)

Once the prosecution was able to establish all the elements of the crime contained in the Section beyond a reasonable doubt, a fine of up to R2 000,00 or imprisonment of up to two years or both is prescribed by **Section 441 (1)(b)**. This is wholly inadequate as the opportunity cost of insider trading is more than likely to offset the deterrent effect of the sanction.

This unfortunate state of affairs probably best illustrates the need for a clear formulation of policy before progress can be made in eliminating insider trading. If the primary basis of the **1973 Act** was to deter insider dealing, as it appears to have been, then the penalty imposed upon the dealer is paramount. (21) This criteria has not been met by the provisions enacted.

A further problem has been that it is likely that prosecutions will be brought before a magistrate's court, which is obviously not the best kind of tribunal for the complex legal problems that are likely to arise. (22)

Apart from the enactment of a substantive anti-insider trading provision, the **1973 Act** contained disclosure provisions which it was clearly felt would aid the detection of the outlawed conduct.

Where trading amounting to a contravention of the prohibition was transacted on a face to face basis, the legislature has taken the approach that the identification of the parties, the volume of securities, and their price are generally easily obtained from one or other of the parties.

(19) Ibid, p. 445.

(20) Ibid, p. 445.

(21) White, R.C.A.; Towards a Policy Basis for the Regulation of Insider Dealing; (1974) 90 LQR p. 503.

(22) Rider, B.A.K.; The Regulation of Insider Trading in the Republic of South Africa; (1977) 94 SALJ p. 445.

However, where the trading of securities takes place on the anonymous markets of the stock exchange, the Commission had concluded that a statutory duty of disclosure in respect of companies whose shares were listed would be extremely important in assisting in the enforcement of criminal sanction.

Accordingly, **Section 230** provided that every public company having a share capital was to keep a register of the material interests of its directors, past directors, officers and other defined persons in its shares and debentures. This section as read with **Sections 231 and 232** set detailed parameters within which the disclosure is to take place, so much so in fact, that they have been described (23) as provisions which practically defeat the object by the virtually impossible burden created in respect of the interests that had to be recorded.

The test of the efficacy of the statutory disclosure provisions was always going to be the number of successful prosecutions under **Section 233**, and using this yardstick it was obvious that they were sadly deficient.

The problem essentially is that the question of the enforcement of the prohibition on insider trading was completely glossed over. Despite the previous Report of the Millin Commission which in 1948 recommended a strengthening of the investigatory powers of the Registrar of Companies, the Van Wyk de Vries Commission considered that in fraud cases the Commercial Frauds Branch of the South African Police was sufficiently competent. The Commission also concluded that the office of the Registrar of Companies was competent and adequate. In the view of the Commission any notion of increased administrative control should be completely rejected. (24)

This attitude was not surprising given the strength of the stockbroking lobby in matters affecting securities law, who clearly felt it unnecessary that rules be promulgated to police the provisions of the Act.

Given the precedents set by the American Securities and Exchange Commission and the British Department of Trade, the Commission's approach was inexcusable, even though in its Supplementary Report it emphasised the importance of the Exchange exercising continuous surveillance over listed companies and the desirability of close co-operation between the self-regulatory and official authorities. (25)

This did however not materialise and the lack of a method of enforcement was destined to relegate the insider trading provisions of the **1973 Act** to the cobwebbed corners of our companies legislation.

In the cold light of academic analysis, it is not perhaps uncharitable to describe the South African statutory provisions as an unholy jumble or even a statutory mess. (26)

(23) Cilliers, H.S. and Benade, H.S. (Eds); Corporate Law; (1987) p. 237.

(24) Rider, B.A.K.; The Regulation of Insider Trading in the Republic of South Africa; (1977) 94 SALJ p. 446.

(25) Rider, B.A.K.; op cit p. 447.

(26) Ibid, p. 445.

An increasing world-wide awareness of the socio-economic effects of insider trading abuses and a consequent burgeoning of the interest of both jurists and the legislatures of the economically developed world in the problem of its regulation, caused attention to once again be paid to the situation in the Republic.

The Standing Advisory Committee on Company law initially considered the enactment, firstly, of presumptions against any person alleged to be guilty of insider trading with the onus of rebuttal on such persons, and secondly, of provisions for an inspector, or stock exchange ombudsman to conduct investigations, with an obligation upon the interrogated person to answer questions and provide information, but with a safeguard of confidentiality in the court's discretion. (27)

Rather than making attempts to patch inadequate legislation, a more considered approach was obviously required. It was necessary to scrutinise questions of public policy, and from a declared policy point of view to examine and adapt the legislative reform which had taken place in foreign jurisdictions, so that a workable model could be found for South Africa.

3. LESSONS FROM FOREIGN JURISDICTIONS

The regulation of insider trading has always been a matter of concern in developed securities markets. Since 1934, there have been strict anti-insider trading laws in the United States of America. In recent times, the question has received considerable attention in the United Kingdom.

3.1 UNITED STATES OF AMERICA

At common law, the United States was quick to dispense with the precedent set in Percival vs Wright. The modern view began with the seminal decision in Strong vs Repide (28) where it was held that, although a director has no general duty to disclose facts known to him when dealing in securities, such a duty does arise where there are "special facts" such as an impending merger or liquidation not at the time known to the other party. (29)

However, prompted no doubt by the Stock Market Crash of 1929 and the Great Depression which followed, the federal authorities decided to step in and actively regulate the securities market.

The point of departure of all American federal legislation is, as a result, a policy decision to protect the market investor, not by the pure criminalisation of insider trading, but by an emphasis on the disgorgement of profits made as a result of the practice. An attitude which it is submitted, addresses the essence.

(27) Financial Mail, 12 October 1984 p. 110.

(28) 213 U.S. 419 (1909)

(29) White, R.C.A.; Towards Policy Basis for the Regulation of Insider Dealing; (1974) 90 LQR p. 503.

The first step along the road was the promulgation of the **Securities Act, 1933.** (30) **Section 17 (a)** of this Act provides a stringent anti-fraud rule in connection with the sale of securities and this would seem to have been a section designed to catch all undesirable stock promotional practices not otherwise caught. (31). Its use however has been hampered by the exclusion of purchases of securities from its ambit.

A second, and more potent step, was taken by means of the **Securities Exchange Act 1934.** (32) It promulgated more general provisions prohibiting fraud, manipulation and deception in transactions involving securities, and introduced a body, the **Securities and Exchange Commission** ("the SEC") to enforce the insider dealing prohibitions.

Originally, the primary prohibition on insider trading was contained in **Section 10 (b) of the 1934 Act.** This section is a general provision dealing with both purchases and sales of securities and made it unlawful 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 any manipulative device or contrivance or deception in contravention of rules (to be adverted to later) made by the SEC for the protection of investors or in the public interest.

This general prohibition was supplemented by the disclosure provisions contained in **Section 16 (a).** The section has been summed up (33) as requiring every director or officer of a company with a registered equity security, as well as every beneficial holder of 10% of any class of registered equity security, to file reports with the SEC to be received by the SEC ten days after the close of every calender month indicating any changes in his beneficial ownership. A report must be filed for each month in which there has been a change even though at the end of the month the holdings are zero or the balance of purchases and sales has resulted in no nett change in holdings over the month. In 1964 the reporting requirements were extended to include unlisted companies with assets of $1 million and 500 shareholders.

In order to give effect to the federal legislature's decision to protect investors by allowing a disgorgement of the profit made by an insider by means of a prohibited securities deal, it enacted **Section 16 (b),** the so called "short-swing profit rule". The section permits recapture by the company of any profit realised by a person within Section 16 (a) from a purchase or sale of any equity security in his company within six months and if the company does not sue within sixty days of a request to do so, any security holder may bring an action in the company's name. (34) This provision was in essence an anti-manipulation device aimed at "classical" insiders and as such needed supplementation if insider dealing was to be effectively prohibited.

In 1936 Congress amended the **1934 Act** to include a general anti-deception section, now **Section 15 (c)(i),** applicable to brokers and dealers in their purchases or sales of over-the-counter stocks and the section gave the SEC broad power to make rules for the regulation of broker dealers including power to prohibit insider dealing in unlisted securities. (37)

(30) 15 U.S.C.A. s 77.

(31) White, R.C.A.; op cit p. 504.

(32) 15 U.S.C.A. s 78.

(33) White, R.C.A.; op cit p. 503-504.

(34) Ibid, p. 504.

(35) Ibid, p. 504.

The need to spread the net of the insider trading prohibition as wide as possible resulted in 1942 in the promulgation by the SEC of what is now **Rule 10b-5.**

This Rule provides that it shall be unlawful for:

"any person directly or indirectly, by the use of any means of instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

(1) to employ any device, scheme or artifice to defraud;

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or;

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

It has been said (36) that the rule is a combination of the jurisdictional coverage of Section 10 (b) with substantive aspects of Section 17 (a) of the 1933 Act. Whatever the case, its sweeping provisions coupled with the SEC's regulatory powers and the concomitant body of judicial precedent which has arisen to govern its interpretation, have ensured its prominence as the key American anti-insider trading provision.

The implementation of the rule depends, in the first instance, upon the disclosure requirements of Section 16(a) of the 1934 Act. The SEC collates all the information required to be forwarded to it concerning securities transactions. Those transactions became a matter of public record and are frequently published in newspapers and financial journals.

In addition to this monitoring of unduly voluminous share trading by certain people, the stock exchanges are often relied upon to unearth unusual security price movements which may be indicative of insider trading. Evidence of possible violations are collected by a stock exchange sub-committee and passed on to the SEC or other relevant government department.

Importantly, the SEC itself has wide investigatory powers and has the full right of *subpoena* to accomplish this task. The criminal prosecution of offenders is however left to the Department of Justice. This sanction is further supplemented by private civil actions against offenders which are routinely allowed by the courts.

A now considerable body of case law has embellished Rule 10b-5 and has done much to provide jurisdictions such as ours with guidance concerning the question of the regulation of insider trading.

In the case of SEC vs Texas Gulf Sulphur Co (37) the judiciary emphasised that the object of the provisions was to provide equal access to material information for share dealing, but that such object only required the disclosure of basic facts to enable corporate outsiders to reach their own investment decisions.

The facts in this case were that the company had, in an attempt to diversify, obtained land in Eastern Canada which was found to be rich in minerals. Various corporate insiders bought shares and tipped others creating rumours which were dampened by a press release. More insider dealing however took place before the full extent of the ore strike was disclosed to the public.

(36) Ibid. p. 505.

(37) 312 F Supp 77 (1970)

The Court of Appeals held that such corporate insiders may not deal in securities of the company while material insider information remained unpublished. It was emphasised that the degree of materiality required was to be objectively ascertained and would include all situations extraordinary in nature which would be likely to have a substantial effect on the market price of the security. The Court also expressed itself strongly on the question of "tippees", warning that the conduct of persons receiving tips was as reprehensible as that of the insider passing the tips and suggesting that they too might be held liable.

The question of the appropriate remedy was deferred but was greatly influenced by the decision in the case of Diamond vs Oreamuno. (38) In deciding the matter under the relevant New York State law, it was held that directors who trade on inside information may be liable to the company for their personal gains, even though it was not the actual person who had suffered damages.

Here the facts were that directors had sold their shares to avoid a loss, fully knowing that the publication of the company's poor monthly earnings would reduce the value of the securities. The company itself was accordingly to be allowed a remedy as it was felt that the court's primary concern should be to see that corporate officials who abuse inside information should never be able to retain profits which they derived as a result.

This decision has prompted approval by the courts of escrow funds into which such profits could be paid, and which the company could utilise subject to judicial direction.

In Schein vs Chasen (39) the Court of Appeals for the Second Circuit adjudicating in terms of the Laws of Florida extended the Diamond vs Oreamuno *supra* principle to cover "tippees" if they knowingly joined a person in a fiduciary capacity in a common enterprise to trade on the basis of confidential information.

Recently, however, the rather open-ended approach by the Courts to the concept of who is an insider was narrowed. In United States vs Chiarella (40) an employee of a financial printing house used inside information obtained from take-over bid brochures to make a profit on the purchase and sale of shares in the target company. It was held that such an employee could not be an insider as he did not occupy a fiduciary or similar relationship of trust and confidence.

Although the court reaffirmed application of the prohibition to "classical" insiders, the decision has been criticised (41) as being a severe setback to the evolving American concept of the quasi-insider.

Despite this decision it can be appreciated that judicial interpretation of the SEC Rule 10b-5 has generally seen a gradual broadening of the regulatory bases of insider trading. This can be noted in pronouncements concerning the persons to be included in the category of insider, and in the remedies afforded to those who suffer damages.

(38) (1966) 248 NE 2d 910 (NY Court of Appeals)

(39) (1973) 478 F (2d) 817.

(40) 445 US. 222 (1980)

(41) Branson, D.M.; Insider Trading - I: The British Regulation in the Light of the American Experience; 1982/83 JBL p. 348.

In a comment on the Texas Gulf, Diamond and Schein decisions, it has been said (42) that this line of cases illustrates the process of growth and refinement of regulation of insider dealing and the advantages of a clearly enunciated policy are apparent. Expressed with a brevity that might not do it justice, the policy would seem to be that the best protection for the market investor against insider dealing is a policy of deterring the insider from dealing on the basis of confidential information by never permitting him either to retain the profit he has made or to avoid the loss he knew was imminent when he dealt. It has been accepted that it is not always possible to provide a remedy for the market investor although whenever practicable a remedy will be granted. The enunciation of such a policy has enabled the courts to be creative in their approach to regulation of insider dealing and thus to ensure that the most serious abuses are proscribed. Further the vigilance of the SEC has ensured that the abuses are examined by the courts. The American experience has shown that the complexity of this kind of securities regulation does not admit of any easy answer nor does it submit itself readily to the skill of the draftsman's pen. The definitions must remain to a degree open-ended and permit flexibility. Such flexibility can only be achieved by acknowledging the important role of the judiciary who by applying the basic policy behind any legislation can ensure that the law in this area is abreast of current market practices and not way behind them.

3.2 UNITED KINGDOM

The British approach to the regulation of insider trading differs fundamentally from her American counterpart as legislative codification has enjoyed a preference to judicial development of securities law.

The case of Percival vs Wright (43) at the turn of the century was the stumbling block which effectively prevented the common law regulation of the practice. Adopting a *liassez-faire* attitude prevalent at the time, Swinfen Eady J. concluded: (46)

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

Certain decisions within the Commonwealth (45) were able to find sufficient distinction to bring equity to bear on the particular matter, but the judiciary was never able to successfully overcome the precedent set by the case. It was stated unequivocally (46) that the case presented a major difficulty to any case law development in this area and for a decision at first instance has had an influence on the development of certain aspects of company law unparalleled by more than a handful of other cases.

As considerations of capitalist economic expediency began to wane, the decision came under increasing criticism as conflicting with notions of commercial morality.

(42) White, R.C.A.; Towards a Policy Basis For the Regulation of Insider Dealing; (1974) 90 LQR p 507-8.

(43) [1902] 2 Ch. 421.

(44) Ibid p. 426.

(45) Allen vs Hyatt (1914) 30 TLR 444; Coleman vs Meyers [1977] 2 NZLR 225.

(46) White, R.C.A.; Towards a Policy Basis for the Regulation of Insider Dealing; (1974) 90 LQR p. 496.

This, allied with the perceived necessity in financial circles to maintain and even enhance investor confidence in the stock market, led to some measure of stock exchange self-regulation. To an extent the safeguards introduced to curb insider trading in listed securities, a refined form of which is the current Model Code, were the first signs of a manifest need for efficient regulation.

As a result, it would seem, of the Stock Market Crash in 1929, the legislature formulated its first body of statutory rules designed to protect the investor. **Sections 95 to 99 of the Companies Act 1929** required the disclosure of certain information concerning securities deals on the apparent premise that if dealings were open and certain details were published, then dealing would be honest. (47)

The Cohen Committee which reported in 1945 did not take the matter much further. Indeed, the Committee was careful to point out that it had no wish to fetter the ability of directors to deal in company securities and merely recommended the strengthening of the system of disclosure by the provision of a register of directors' holdings of and transactions in securities of their company and of its subsidiaries, fellow subsidiaries or holding company. (48)

In effect, the rule in Percival vs Wright was to remain, it being felt, rather naively it is submitted, that:

"the best safeguard against improper transactions by directors and against unfounded suspicions of such transactions is to ensure that disclosure is made of all their transactions." (49)

These recommendations were embodied in **Section 195 of the Companies Act 1948** and thus the policy of disclosure came to be coupled with a policy of unrestricted dealing in securities as far as possible. (50) Some effort was however made to ameliorate the plight of those aggrieved by insider trading in that the **1948 Act** contained provisions whereby the then Board (now Department) of Trade could appoint inspectors with investigatory powers.

The matter was again taken up by the Jenkins Committee but their Report, submitted in 1962, contained little in the way of innovation. Its recommendations were embodied in **Sections 27 to 34 of the Companies Act 1967** and amounted to little more than a closing of loopholes in the system of disclosure.

Sections 27 to 29 of the 1967 Act replaced Section 195 of the 1948 Act and contained technical rules aimed at ensuring complete disclosure of interests in securities of the company. The rules related mainly to directors; shareholders being only required to disclose their holdings of securities if they held 10% or more of the issued share capital of a quoted company. There was however no sanction against the practice of "warehousing", where a number of parties acting in undisclosed concert seek to acquire in secret a dominant position in the company in preparation for a take-over bid. However, in one respect there is evidence in the 1967 legislation of a slight change in policy. Under Sections 25 and 30 certain dealing was prohibited; directors were not permitted to deal in options in securities of their company or a company belonging to the same group of companies since such actions were considered to amount to unacceptable speculation with the use of inside information. The prohibition did not extend to options to subscribe for shares or debentures since the terms on which these options were given were considered a matter for the company alone. (51)

(47) White, R.C.A.; op cit. 497.

(48) Ibid, p 497.

(49) Cmd. 6659, para. 87.

(50) White, R.C.A.; op cit. p. 497.

(51) Ibid, p 497-498.

During the early 1970's the possible regulation of insider trading received considerable attention. In July 1973, the Department of Trade and Industry issued a White Paper announcing the Government's intention of introducing legislation containing provisions aimed at the prohibition of insider dealing in securities. In December 1973, the Conservative Party introduced a Bill which made a sweeping attack on the issue and which, if it had reached the statute-book, would have provided civil and criminal sanctions against insider trading. (52)

The Bill's provisions however occasioned a furore in business and financial circles and was jettisoned in favour of the existing legislation. **Sections 24 to 27 of the subsequent Companies Act, 1976**, did however amend and improve the provisions of the 1967 Act.

In legal circles the discussion continued as to whether insider trading was sufficiently widespread or harmful to justify the statutory inhibitions. Among many jurists there existed strong justification for the regulation of the practice. It was even proposed (53) that **Section 13 of the Prevention of Fraud (Investments) Act 1958** which had been on the statute book for many years could be adapted to address the issue of insider trading.

The Labour Party's 1978 Bill contained a revised version of the provisions of the Conservative's 1973 Bill and it appeared that even City opinion had become reconciled to the enactment of criminal sanctions against insider dealing, though there was strong criticism of the wording of some of the proposals (54). These criticisms by City establishments was evidenced by the fact that the 1979 Bill introduced by the present Tory government dropped any attempt to cover private dealings or to provide for statutory civil, as opposed to criminal, remedies. (55)

Nevertheless, **Sections 68 to 73 of the Companies Act, 1980** were a landmark in British efforts to regulate insider trading.

The basic prohibition was contained in **Section 68 (1)** which provided that:

"an individual who is, or at any time in the preceding six months has been, knowingly connected with a company shall not deal on a recognised stock exchange in securities of that company if he has information which:

(a) he holds by virtue of being connected with the company;

(b) it would be reasonable to expect a person so connected and in the position by virtue of which he is so connected not to disclose except for the proper performance of the functions attaching to that position; and

(c) he knows is unpublished price-sensitive information in relation to those securities."

The class of insider affected by the prohibition was clarified by **Section 73 (2)** which stated that:

"an individual is connected with a company if, but only if,:

(a) he is a director of that company or a related company; or

(52) Gower, L.C.B.; Modern Company Law; 1988 Cumulative Supplement, p. 632.
(53) Rider, B.A.K.; The Crime of Insider Trading; 1978/79 JBL p.19.
(54) Gower, L.C.B.; Modern Company Law; 1988 Cumulative Supplement. p [101]-[102].
(55) Gower, L.C.B.; op cit p [101].

(b) he occupies a position as an officer (other than director) or employee of that company or a related company or a position involving a professional or business relationship between himself (or his employer or a company of which he is a director) and the first company or a related company which in either case may reasonably be expected to give him access to information which, in relation to securities of either company, is unpublished price-sensitive information, and which it would be reasonable to expect a person in his position not to disclose except for the proper performance of his functions."

These provisions in effect created a wide class of "classical" insider. Furthermore, **Section 68 (3)** brought the "tippee" within the net, in fact, both classes of insider could be guilty of an offence resulting from a single insider deal.

The term "unpublished price-sensitive information" contained in **Section 68** was also defined in **Section 73(2)** as being:

"information in relation to the securities of a company which:

(a) relates to specific matters relating or of concern (directly or indirectly) to that company, that is to say, is not of a general nature relating or of concern to that company; and

(b) 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."

Certain types of securities deals were however specifically excluded from the ambit of the prohibition which carried the penalty of imprisonment for two years or a fine or both.

The prohibition on insider trading contained in the 1980 Act was supplemented by **Sections 63 to 83 of the Companies Act, 1981** which made extensive reforms to the disclosure requirements particularly in respect of shareholders.

In 1981 Professor L.C.B. Gower was appointed by the Secretary of State for Trade to review investor protection and control of dealers in securities, investment consultants and investment managers. Professor Gower produced a discussion paper on which there was widespread consultation. This was followed in 1984 - 1985 by his report. (56)

It can be said that in many respects, the Gower enquiry mirrored the Government's concern about the financial industry. This concern resulted in certain additional provisions being incorporated into the **Companies Act, 1985. Sections 198 to 220** replaced the disclosure requirements of Sections 63 to 83 of the 1981 Act and have been described (57) as fearsomely complex. **Section 323 of the 1985 Act** furthermore made it an offence for a director or his spouse or minor child to buy a "put" or "call" or "put and call" option in any listed shares or debentures of any company in the group. This applies whether or not he had "published price-sensitive information"...; such transactions are essentially speculative and those who are in a position to acquire inside information should not gamble. (58)

(56) Hahlo, H.R. and Farrar, J.H.; Hahlo's Cases and Materials on Company Law; Third Edition (1987) p. 207.

(57) Gower, L.C.B.; Modern Company Law; 1988 Cumulative Supplement; p. [102].

(58) Gower, L.C.B.; op cit; p [106].

In addition, the entire body of statutory prohibition against insider trading as contained in the 1980 Act was reviewed and it was decided that henceforth its regulation would be effected by a single statute, the **Company Securities (Insider Dealing) Act 1985.**

The Act contained with some modifications, the anti-insider trading provisions of the Companies Act, 1980. It is an offence for an individual who is or has within the preceding six months knowingly been connected with a company to deal as principal or agent on a recognised stock exchange in shares or debentures of that company if he possesses information which he has acquired by reason of being connected with the company, and it is information which it would be reasonable to expect a person in his position not to disclose otherwise than for the purpose of fulfilling his functions as a person so connected with the company (i.e. the information is confidential) and he knows that the information is price-sensitive in relation to the securities. (59)

An individual is treated as connected with a company if, and only if, he is a director of it or its "related company" or, to summarise, "he occupies a position as an officer (other than director) or employee of that company or a related company or a position involving a professional or business relationship" with that company which may reasonably be expected to give him access to inside information which is unpublished price-sensitive information in relation to the securities of a company or a related company. (60)

The second type of insiders are public servants or former public servants who obtain price-sensitive information relating to a particular company by virtue of their position as public servants and who thereby become regarded as insiders of that company. The third type are those, described in American parlance as "tippees", who directly or indirectly obtain information, from a connected person or a public servant. (61)

Before liability can attach to any insider, it must be shown that such person entered into a prohibited transaction on the strength of the unpublished price-sensitive information which he possessed. The Act is mainly concerned with dealings on a "recognised stock exchange", but its scope is widened and dealing on a "recognised stock exchange" includes dealing through an "investment exchange". The scope is extended still further to dealings in "advertised securities" through or by an off-market dealer who is making a market in the securities. (62)

Furthermore, both counselling or procuring any other person, and, communicating the information to any other person, so that he may deal or counsel or procure another person to do so, are banned. (63)

The penalties for a breach of the statutory provisions of the Act remain imprisonment for a term not exceeding two years or a fine or both.

There are a number of exemptions from criminal liability for insider dealing. Briefly, these relate to transactions motived otherwise than with a view to making a profit or avoiding a loss; dealings in the Eurobond market; any transaction in the exercise in good faith of an individual's functions as liquidator, receiver or trustee in bankruptcy, or of a jobber's business (or market maker's) so long as the undisclosed price-sensitive information was such as it would be reasonable to expect him to have obtained in the ordinary course of business; (64) transactions by trustees or personal representatives of estates

(59) Pennington, R.R.; Company Law; 5th Edition (1985); p. 431.

(60) Gower, L.C.B.; Modern Company Law; 1988 Cumulative Supplement p. [107].

(61) Gower, L.C.B.; op cit; p. [107].

(62) Ibid, p. [107] - [108].

(63) Ibid, p. [108].

(64) Ibid, p. [109].

acting on the advice of an appropriate person not appearing to be prohibited from dealing in the securities himself; (65) and acts which relate to the securities of the company of which the individual was not an insider and which are undertaken to facilitate the completion of a transaction between two companies. (66)

Summing up the Act, it has been said (67) that the new provisions may.... be regarded as somewhat timid and they are unlikely to prove to be the last word on this vexing problem.

Indeed, as a result of the Gower Report, the Government produced a White Paper which resulted in the **Financial Services Act, 1986. Sections 177 to 178** contain provisions whereby the Secretary of State may appoint inspectors to investigate suspected insider dealing. (68) The Act stopped short of setting up a Securities Commission as such, but it certainly appears from the House of Lords decision in **Re an inquiry under the Companies Securities (Insider Trading) Act 1985** (69) that the judiciary will lend some support to such inspectors in the execution of their duties. Should this prove the case, then, it is submitted, the common law might take its rightful place in the British regulation of insider trading.

As if to lend some credence to the tentative steps taken by the House of Lords, the **Companies Act, 1989** does contain some new provisions to bulwark the investigations into and the prosecutions in connection with insider dealing. **Section 74 of the Act** amends Section 177 of the Financial Services Act, 1986 to give the Secretary of State additional powers in relation to the appointment of inspectors, whilst affirming banker-customer privilege. **Section 209 of the Act** modifies the Companies Securities (Insider Dealing) Act, 1985, so as to empower the Secretary of State, and not only the Director of Public Prosecutions, to give consent to the bringing of prosecutions for breaches of the Act. (70)

4. THE 1989 AMENDMENTS

The seeds of a new attempt to combat abusive insider trading had been planted in **Section 233 of the Companies Act, 1973.**

South Africa with its sophisticated economic system had determined that the law should regulate the activities of a trader who deals in securities whilst in possession of inside information. The form of its regulation however, dictated as it was by considerations founded in notions of the impropriety and dishonesty of the practice, was one of criminalisation which proved a blunt method of enforcing the prohibition.

During the 1980's there came about a gradual change in social conscience, business morals and financial ethics. These changes forced a fresh look at the policy considerations relating to the issue of insider trading.

A key event which undoubtedly forced the issue was the 1987 Stock Market Crash. Confidence in the equanimity of the stock exchange was undermined and as a result world markets were abandoned by the small investor. This led to the JSE's Tony Norton to comment:

(65) Pennington, R.R.; Company Law; 5th Edition (1988); p. 933.

(66) Gower, L.C.B. Modern Company Law; 1988 Supplement; p. [109].

(67) Gower, L.C.B.; op cit. p. [110].

(68) Ibid. p. [110].

(69) (1988) I All ER 203 (HL).

(70) Buckley on the Companies Acts; Special Bulletin: The Companies Act 1989; (1990) p. 358.

> "The small investor feels threatened by the new markets and systems. Markets are dominated by huge market makers and there are new and difficult conflicts of interest. The sheer complexity and volatility frightens the small man out.
>
> Lace this with two well-publicised (US) wholesale insider trading cases and some market manipulation and his fears are confirmed. He surrenders his discretion to one of the giants and compounds the problem" (71)

University of the Witwatersrand law professor Michael Katz was accordingly tasked with the drafting of new provisions to regulate insider trading. At an Institute of Directors conference in June 1989 he warned that the new legislation would "irreversibly batter insider trading". It was stated that the primary objective of the amending legislation would be to end insider trading and govern the vexed and often linked area of transfers of control.

Hinting at the policy basis of the new provisions, Katz pointed out that the recent Drexel case in the US had shown that tiny predators could take over massive targets. This led to "corporate insecurities", with executives' skills distracted as they watched over their shoulder. He mentioned further that whilst some people still questioned the need for regulation, insider trading created a systematic bias against prompt disclosure and undermined investor confidence. (72)

It was accordingly clear to all that a fundamental shift in policy had taken place. One of the most important policy choices which appeared to have been taken was that all market investors or potential market investors should have equal access to information about a company upon which a decision to buy or sell securities in that company can be based. This, together with the allied considerations alluded to above, were destined to change the face of the South African regulation of securities transactions.

During May 1989, the Companies Amendment Bill was introduced and following a smooth passage through Parliament was assented to on 1 June 1989, the Afrikaans text having been signed by the State President.

The Companies Amendment Act, No. 78 of 1989 was published in Government Gazette No. 11932 of 9 June 1989 and contained the following preamble:

> "To amend the Companies Act, 1973, so to provide for certain fees to be prescribed by regulation; to provide for the establishment of a Securities Regulation Panel; to prescribe the functions and powers of the said panel; to determine the administration and financing of the panel; to prohibit certain dealings in securities; to place an obligation on certain persons to furnish information; and to further regulate and prescribe penalties for offences; and to provide for matters connected therewith."

It was hence spelt out in no uncertain terms that the object of the amending legislation was to effect a change in the Government's approach to the treatment of insider trading.

Section 1 of the Amendment Act deals with the arrangement of the principal 1973 Act inserting in its description of contents a Chapter XVA consisting of Sections 440A - 440J concerning the "Regulation of Securities".

It is interesting to note that despite the trend in the United Kingdom, evidenced by the Companies Securities (Insider Dealing) Act, 1985, our legislature decided not to regulate securities by means of a single, separate act, but to rather incorporate the new provisions into the existing Companies Act.

(71) Financial Mail; Insider Trading: From the outside; June 16, 1989; p. 38.

(72) Financial Mail; op cit; p. 38.

This approach has had the effect of enlarging an already bulky principal Act, but was no doubt motivated by the fact that the insider trading provisions were to apply to company securities, and not to dealings in members interests in close corporations. It is submitted that whilst in one respect it is necessary to keep all legislation regarding companies within the existing Companies Act, it is inevitable that growth in securities regulation will necessitate a separate statute such as the British act.

Sections 2 and 3 of the Amendment Act deal with provisions for the prescription of certain fees to be effected by means of regulation, and need not be of concern to us here.

Section 4 of the Amendment Act contains the new provisions governing the regulation of securities:

At its essence is the prohibition of insider trading.

"Prohibition of use of fraud, deceit or artifice in dealings in securities.

440F.

(1) Any person who, directly or indirectly, in connection with the purchase or sale of any security:-

(a) employs any device, scheme or artifice to defraud any person;

(b) makes any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

(c) engages in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

shall be guilty of an offence.

(2) Any action specified in paragraph (a), (b) or (c) of subsection (1) includes:-

(a) any director, past director or officer of a company or any person connected with a company having knowledge of any information likely, when published, to affect the price of securities of that company, dealing, except for the proper performance of the functions attaching to his position with that company, in securities before the expiration of a period of not less than 24 hours after such information has been publicly announced for the first time on a stock exchange or in a newspaper or through the medium of the radio or television or by any other means;

(b) any other person, having directly or indirectly received from any person mentioned in paragraph (a) such information, so dealing, on the basis of such information, in such securities at a time when the said person mentioned in paragraph (a) may in terms of that subsection not so deal in such securities.

(3) Any person who contravenes subsection (1), or subsection (2) as applied by subsection (1), shall, subject to any defence that may be available to him, be liable to any person for any loss or damage suffered by him as a result of such contravention.

(4) The provisions of this section shall not apply to dealings in members' interests in close corporations."

Section 440F(1) of the Act contains what can loosely be referred to as a general anti-fraud provision. It maintains the criminal sanction imposed by means of the old Section 233, but significantly widens its import.

The section is firmly modelled on Rule 10b-5 promulgated by the American Securities and Exchange Commission and we accordingly can expect our judiciary to draw substantially on the body of precedent which has embellished that particular rule.

Section 440F(2) of the Act is in effect very much of a legislative codification of the case law surrounding Rule 10b-5. It is gratifying to see that the prohibition contained in Section 440F(1) is expressly stated to effect both classical insiders and the so-called "tippee". In terms of the South African position, this is a substantial step forward, though the amending legislation stops short of bringing more remote secondary insiders, such as public servants and former public servants as in Britain, within the net of liability.

The persons affected by the criminal sanction are "any director, past director, or officer of a company, or any person connected with a company." It has been pointed out (73) that no problems arise with the words "director" or "officer" as they are defined in s1 of the 1973 Act. The terms "past director", "officer" and "person", however, are defined in s229 of the 1973 Act, but this section is to be repealed and not to be replaced. At present the term "past director" means a person who has ceased to be a director of the company concerned for a period not exceeding six months; when the relevant part of the 1989 Act comes into operation the term will carry only the obviously broad meaning, namely, a person who was once a director of the company concerned.

It is further noted (74) that also, there is no definition of the phrase "any person connected with a company", an omission which again leaves the phrase open to an extensive interpretation. Perhaps some assistance can be found in the definition of the phrase "an individual connected with a company" which appears in the insider dealing section of the English Companies Act 1980.

The section in the 1980 Act which was incorporated into the subsequent Company Securities (Insider Dealing) Act, 1985, included as insiders directors of related companies and, in addition, other officers and employees of the company or a related company together with persons in positions involving professional or business relationships reasonably likely to make them privy to inside information which was potentially price-sensitive.

It certainly seems likely that under the new insider trading prohibitions persons falling into the latter category of professional and business advisers will need to tread exceedingly lightly.

As regards the "inside information" upon which must be traded, Section 440F (2) (a) states that there must be knowledge of information likely, when published to affect the price of securities of the company. This differs from the standard set previously by Section 233 which required knowledge of information which may be expected materially to affect the price of shares or debentures of the company. This is further evidence of a tightening of the prohibition.

It has been said (75) that one of the major differences between s 440F (2) (a) of the 1989 Act and s 233 of the 1973 Act is the time limit within which the insider

(73) Luiz, S.M.; Insider Trading: A Transplant to Cure a Chronic Illness? (1990) 2 SA Merc LJ. p.63.

(74) Luiz, S.M.; op cit; p. 63.

(75) Ibid, p. 63.

is not entitled to deal. Under s 233 he was not entitled to deal to his advantage, directly or indirectly, until the information had been made public. The moment there had been publication on a stock exchange, in a newspaper, or on the radio or television, the bar against dealing was lifted.But under 440F(2)(a) an insider is not entitled to deal for a full 24 hours after the announcement has been made. Although this provision is obviously designed to allow the market time to digest the information, it effectively places the insider at a distinct disadvantage, since in many instances the market will not require the full 24 hours. Not only is the time limit arbitrary but it may well encourage artificial timing of announcements by directors, for example, at the close of trading on a Friday.

The penalties for a breach of the statutory criminal provisions of the 1989 Act are welcome news to those concerned with the deterrent aspects of the insider trading prohibition. **Section 5 of the Amendment Act** provides, *inter alia,* that:

"Section 441 of the Principal Act is hereby amended by the substitution for subsection (1) of the following subsection:

'(1) Any company, director, officer or person convicted of any offence referred to in any of the undermentioned sections shall be liable to be sentenced, in the case of an offence referred to:-

(a) in Section 440F(1) or (2), to a fine not exceeding R500 000,00 or to imprisonment for a period not exceeding 10 years or to both such fine and such imprisonment;'....."

The current situation is indeed a far cry from the provisions under the old Section 441(1)(b) which authorised a penalty of a R2 000,00 fine or 2 years imprisonment or both.

Liability in respect of the criminal sanction imposed by the new Act would appear to follow the general requirement that mens rea be established, (76) but in addition, the legislature has provided a statutory limitation of liability by exempting insider deals conducted for the proper performance of the functions attached to the insiders' position with the company. The exemptions in jurisdictions such as the United Kingdom have been more numerous, however, the South African amendments have seen fit to limit such exceptions to those circumstances where dealing has taken place in good faith. It is submitted that having regard to both simplicity and effectiveness, the approach of our draftsmen is to be preferred.

Section 440F(3) of the Act represents the high-water mark of our legislative attempts to curb abusive insider trading. By the imposition of civil liability on a person who contravenes the prohibition, our law gives effect to the policy decision to afford not only protection to the investor, but also a substantial means of obtaining redress. In this respect, South Africa has surpassed both America and the United Kingdom, and has, it is submitted, opened a door which will surely lead to the effective arrestation of insider trading.

Section 440F(4) is perhaps anomalous given the progressive approach of our legislature. By decreeing that the provisions of Section 440F shall not apply to dealings in members interests in close corporations, our draftsmen have perhaps left a loophole which might subsequently have to be closed. Whilst it is clear that much of the legislation is aimed at transactions on the impersonal securities markets of the stock exchange, all deals in securities are affected.

(76) Ibid, p. 61-62.

Given the current preference of businessmen for the close corporation, as opposed to the private company, as a vehicle of commercial enterprise, a situation can easily be envisaged which would necessitate the repeal of this particular amendment and the widening of the definition of a security to include a members' interest.

A lesson well learnt from both the British and the American experience was the need for an effective mechanism for the enforcement of the insider trading prohibition.

Section 4 of the Amendment Act contains South Africa's first major foray into this area of securities regulation:

"Establishment of panel

440B

(1) There is hereby established a body corporate to be known as the Securities Regulations panel.

(2) The members of the panel shall be appointed by the Minister and shall consist of:-

(a) the chairman;

(b) the Registrar;

(c) the chairman of the Competition Board established by Section 3 of the Maintenance and Promotion of Competition Act, 1979 (Act No. 96 of 1979);

(d) such persons as are nominated by the bodies, associations and institutions referred to in subsection (3); and

(e) any person co-opted in terms of subsection (6).

(3) Each of the following bodies, associations and institutions shall be entitled to nominate one person, and in the case of the Johannesburg Stock Exchange three persons, to serve on the panel, namely:-

(a) the Johannesburg Stock Exchange;

(b) the South African Federated Chamber of Industries;

(c) the Association of Chambers of Commerce and Industry of South Africa;

(d) the Afrikaanse Handelsinstituut;

(e) the Clearing Bankers Association of South Africa;

(f) the Association of General Banks;

(g) the Merchant Bankers' Association;

(h) the Shareholders' Association of South Africa;

(i) the Pensions Institute (of Southern Africa);

(j) the Chamber of Mines of South Africa;

(k) the Life Offices' Association of South Africa;

(l) the South African Institute of Chartered Accountants; and

(m) the Association of Law Societies of the Republic of South Africa.

(4) The chairman, who need not be one of the nominated members, shall be designated by the members of the panel nominated in terms of subsection (3).

(5) The panel may designate a member of the panel as acting chairman to exercise and perform the powers and duties of the chairman whenever the chairman is unable to do so or while the office of chairman is vacant.

(6) The panel shall be entitled, from time to time, to co-opt not more than four persons as additional members.

(7) Every member of the panel shall hold office for a period of five years : Provided that any body, association or institution referred to in sub-section (3) may apply to the Minister to have the person nominated by it and appointed by the Minister, replaced by any other nominee before the expiry of his term of office.

(8) If, during any such five-year period, a member of the panel nominated pursuant to the provisions of sub-section (3), dies, becomes incapacitated, resigns, or becomes disqualified from being appointed or acting as a director of a company in terms of Section 218, or ceases for any other reason to be a member of the panel, the vacancy arising in this manner may be filled for the unexpired period of such member's term of office by a person nominated by the body, association or institution of which the member who ceases to be on the panel was a nominee.

(9) A member of the panel shall, on the expiry of his term of office, be eligible for reappointment.

(10) (a) The meetings of the panel shall be held at such times and places as the chairman may determine.

(b) The person presiding at a meeting of the panel shall determine the procedure at such meeting.

(c) The decision of a majority of the members of the panel present at any meeting thereof at which there is a quorum (as determined in accordance with the rules of the panel) shall constitute the decision of the panel, and in the case of an equality of votes, the chairman shall have a casting vote in addition to his deliberative vote.

(d) No proceedings of the panel shall be invalid only of the fact that a vacancy existed on the panel or that any member was not present during such proceedings or any part thereof.

(11) The panel shall appoint an executive director to hold office for such period and on such conditions as the panel may determine.

(12) There shall be an executive committee of the panel, consisting of the executive director and so many members of the panel, of whom one may be the chairman of the panel, as the panel may determine.

(13) The panel may appoint such officers and employees as are required for the proper performance of the panel's functions.

(14) The panel may delegate any of its powers to the executive committee or to any subcommittee of the panel which may be established by the panel."

Section 440B came into operation on 1 October 1989 as decreed by Proclamation R170/1989 which was contained in Government Gazette No. 12112 dated 29 September 1989.

A second step along the path of enforcement of the insider trading prohibition was the delimitation of the functions of the Securities Regulation Panel.

"Functions of panel

440C.

(1) The functions of the panel shall be to:

(a) regulate, in such manner as it may deem necessary or appropriate:-

(i) all transactions or schemes which constitute affected transactions;

(ii) all proposals which on successful completion or implementation would become affected transactions; and

(b) supervise dealings in securities in accordance with the provisions of this Chapter.

(2) It shall not be the function of the panel to judge the commercial advantages of affected transactions.

(3) Without derogating from the provisions of subsection (1), the functions of the panel shall include the making of rules in respect of matters falling within the provisions of this Chapter, including rules relating to the following aspects of affected transactions, namely:-

(i) the duties of the offeror; and

(ii) the duties of the offeree company.

(4) The rules shall make provision for:-

(a) the administration and financing of the panel;

(b) the remuneration and allowances of the executive director and the conditions upon which he is appointed;

(c) the remuneration and allowances of members and officers and employees of the panel, and the conditions upon which such members, officers and employees are appointed;

(d) appeals from decisions of:-

(i) the executive director to the executive committee referred to in subsection (12) of the Section 440B;

(ii) the said executive committee to the panel; and

(iii) a subcommittee of the panel to the panel.

(5) Rules made or amended by the panel and approved by the Minister shall be published by notice in the *Gazette.*

(6) The panel or its executive committee or its executive director may:-

(a) consult with any person at the request of any interested party in a proposed affected transaction with a view to interpreting any aspect relating to any of the rules which have been made by the panel and which apply to such proposed affected transaction;

(b) Issue information on current policy in regard to proposed affected transactions to serve as guidelines for the benefit of persons concerned in proposed affected transactions;

(c) receive and deal with representations relating to any matter with which it may deal in terms of this Chapter; and

(d) perform any other functions assigned to it by this Chapter.

(7) Nothing in this section contained shall be construed as obliging any person to notify the panel of, or to consult the panel in connection with, a proposed affected transaction."

The functions of the Securities Regulation Panel are clarified by certain definitions contained in **Section 440A:**

" *'panel'* means the Securities Regulation Panel established by Section 440B;..."

" *'affected transaction'* means any transaction or scheme, whatever form it may take, pursuant to which, taking into account any shares held before such transaction or scheme, control of any company (excluding a close corporation) vests in:-

(a) any person; or

(b) two or more persons acting in concert,

in whom control did not vest prior to such transaction or scheme; ..."

" *'control'* means, subject to subsection 2(b), a holding or aggregate holdings of shares or other securities in a company entitling the holder thereof to exercise, or cause to be exercised, the specified percentage or more of the voting rights at meetings of that company, irrespective of whether such holding or holdings confer *de facto* control; ..."

" *'specified percentage'* means the percentage, or different percentages in respect of different types of companies, prescribed in the rules for the purposes of determining control as defined in this section : Provided that the percentage shall in no case fall below 20% of the issued securities of any class..."

" *'security'* means any shares in the capital of a company and includes stock and debentures convertible into shares and any rights or interests in a company or any such shares, stock or debentures, and includes any "financial instrument" as defined in the Financial Markets Control Act, 1989; ..."

For the purposes of elucidating this definition, **Section 440A(2)(b)** provides that:

"A security which is convertible into a voting security shall, even before its conversion, be deemed to confer those voting rights which it would confer after conversion."

Continuing with an examination of the definitions,

" *'company'* includes an external company and any other body corporate;..."

" *'acting in concert'* means, subject to subsection (2)(a), acting in pursuance of an agreement, arrangement or understanding (whether formal or informal) between two or more persons pursuant to which they or any of them co-operate to obtain control of a company by means whatsoever, including the acquisition by any of them of shares or other securities in such company, or the redemption of shares or other securities in such company, or the redemption of shares in, or the reduction of the share capital of, any such company;..."

Section **440A(2)(a)** provides that:

"the following persons shall be deemed to be acting in concert with one another unless the contrary is established, namely:-

(i) a company, its holding company, subsidiaries, companies which are subsidiaries of its holding company and their subsidiaries, and companies of which such companies are associated companies, and for the purposes hereof ownership or control by a company of 20% or more of the equity share capital of another company shall constitute the latter company as the former company's associate;

(ii) a company with:-

(aa) any of its directors;

(bb) any company controlled by one or more of its directors; or

(cc) any trust of which any one or more of its directors is a beneficiary;

(iii) a company with any of its pension, provident or benefit funds; ..."

Section 440A(1) furthermore contains the following definitions relevant to a proper determination of the functions of the Securities Regulation Panel:

" *'acquisition'*, in relation to shares or other securities of any company, means the acquisition of shares or other securities in such company by any means whatsoever, including purchase or subscription; ..."

" *'rules'* means the rules made from time to time by the panel and approved by the Minister and published by him by notice in the *Gazette*; ..."

In addition **Section 440A(3)** provides that:

"When the panel makes rules, it shall, not less than one month before submitting the rules to the Minister for his approval, publish the text of the proposed rules in the *Gazette,* together with a statement of its intention to so submit such rules."

Further, the definition section provides that:

" *'offeror'* means any person or two or more persons acting in concert who enter into or propose any affected transaction; ..."

" *'offeree company'* means any company the control of which changes or is proposed to be changed or is acquired pursuant to any affected transaction or proposed affected transaction; ..."

Finally,

" *'executive director'* means the executive director of the panel appointed in terms of Section 440B(ii);..."

Both **Section 440C** and the related **Section 440A** came into operation on 26 January 1990 as decreed by Proclamation R11/1990 which was contained by Government Gazette No. 12265 dated 26 January 1990.

These provisions allowed the panel, which had been created earlier the previous year, to begin functioning and to lay the foundation for its efforts to regulate dealings in securities.

An additional measure relating to the financing of the Securities Regulation Panel also came into operation on 26 January 1990:-

"Financing of panel

440E

(1) All fees payable under the rules contemplated in Section 440C(4) shall be paid to the panel and shall constitute its funds, and the panel shall utilize its funds for defraying expenses incurred in connection with the performance of its functions.

(2) The panel may invest any unexpended portion of its monies and may establish reserve funds and pay into them such amounts as it may deem necessary or expedient."

The functions of the panel are clearly not only to curb insider trading, but also to check abuse of power in change of control situations.

Given these functions, the Securities Regulation Panel is vested with investigatory powers.

"Investigations by panel

440D.

(1) For the purposes of performing its functions in terms of this Chapter, the panel or any committee thereof may:-

(a) summon any person who is believed to be able to furnish any information on the subject of an investigation or to have in his possession or under his control any book, document or other object which has any bearing upon that subject, to appear before the panel or committee at a time and place specified in the summons, to be interrogated or to produce such book, document or other object; and

(b) interrogate any such person under oath or affirmation administered by the chairman or a person appointed by him, and examine or retain for examination any such book, document or other object: Provided that any person from whom any book, document or other object has been taken and retained under this sub-section shall, so long as such book, document or object is in the possession of the panel or a committee thereof, at his request be allowed, at his own expense and under the supervision of the investigating officer, to make copies thereof or to take extracts therefrom at any reasonable time.

(2) A summons for the attendance of any person before the panel or a committee thereof or for the production to the panel or a committee thereof of any book, document or other object shall be in the form prescribed by the panel, shall be signed by the chairman of the panel or committee and shall be served in the manner so prescribed.

(3) Any person who has been summoned to attend before, or to produce any book, document or other object to the panel or a committee thereof and who, without sufficient cause (the onus of proof of which shall rest upon him), fails to attend at the time and place specified in the summons or to remain in attendance until he is excused by the chairman thereof

from further attendance or, having attended, refuses to be sworn or to make an affirmation after he has been asked by the chairman (or a person appointed by him) to do so or, having been sworn or having made affirmation, fails to answer fully and satisfactorily any question lawfully put to him, or fails to produce any book, document or other object in his possession or under his control which he has been summoned to produce, shall be guilty of an offence.

(4) Any person who, after having been sworn or having made affirmation, gives false evidence before the panel or a committee thereof on any matter, knowing such evidence to be false or not believing it to be true, shall be guilty of an offence.

(5) The law relating to privilege as applicable to a witness giving evidence before, or summoned to produce a book, document or other object to, a provincial division of the Supreme Court of South Africa shall apply in relation to any person summoned under this section.

(6) Nothing contained in this Chapter shall be deemed to compel the production by a legal adviser of a letter, report or other document containing a privileged communication made by or to him as legal adviser, or to authorize the seizure or retention thereof."

A definition contained in Section **440A** is relevant here.

" *'chairman'* means the chairman of the panel designated in terms of Section 440B(4) or (5);..."

The investigatory powers granted to the Securities Regulation Panel are a further major change to the South African securities law position and go a long way towards answering critics of the pre-amendment situation who argued that the main cause of the ineffectiveness of Section 233 was the lack of machinery to investigate insider trading abuses.

Following the lead given by the American Securities and Exchange Commission and the British Department of Trade Inspectors, our Securities Regulation Panel will be able to actively police the prohibitions contained in the Amendment Act.

The task of the panel is aided by the enactment of disclosure provisions similar to that pertaining to the United States of America.

"Obligation to furnish certain information to panel.

440G

(1) Every person who is, or becomes directly or indirectly the beneficial owner of more than 10% of any class of any equity security (other than a security exempted in terms of the rules), which is dealt with on a stock exchange, or who is a director or an officer of the issuer of such security, shall lodge, at the time of the listing of such security on a stock exchange, or within 10 days after he becomes such beneficial owner, director or officer, a statement with the panel (and, if such security is listed on a stock exchange, also with the stock exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within 10 days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the panel (and, if such security is listed on a stock exchange, also with the stock exchange) a statement indicating his ownership at the close of the calendar month and such change in his ownership as has occurred during the calendar month.

(2) Any person who fails to comply with any provision of this section shall be guilty of an offence.

This section is clearly intended to replace Section 230 of the 1973 Act which placed an obligation on public companies to keep a register of interests of directors and others in shares and debentures of the company.

The enforced compliance provided for will enable both the Securities Regulation Panel and the Johannesburg Stock Exchange to monitor any undue movement in the volume of securities held by certain persons. This will undoubtedly deter those affected by it from dealing on the basis of inside information because a sudden increase or decrease in their shareholding (perhaps prior to an announcement of a take-over offer) would become very obvious. (77)

The legislature has laudably used the phrase "beneficial owner" in order to circumvent the use of nominee shareholders to evade the disclosure requirements. No guidance has however been given as to the method of calculating the 10% holding.

As with the case of a breach of the statutory criminal provisions of the 1989 Act, **Section 5 of the Amendment Act** provides, *inter alia*, for stiffer penalties to be imposed on those who fail to comply with the disclosure requirements. A fine not exceeding R20 000,00 or imprisonment for a period not exceeding five years or both a fine and imprisonment may be imposed.

Section 4 of the Amendment Act contains three further ancillary provisions:

"Operation of Chapter in relation to other laws

440H.

The provisions of this Chapter shall be in addition to and not in substitution for any other law which is not in conflict with or inconsistent with this Chapter.

Preservation of secrecy

440I.

(1) No person shall, except for the purposes of carrying out his functions or performing his duties in terms of this Act or for the purpose of legal proceedings under this Act or when required to do so by any court or under any law, disclose to any other person any information acquired by him in the carrying out of his functions or the performance of his duties in terms of this Chapter and relating to the business or affairs of any other person.

(2) Any person who contravenes the provisions of sub section (1) shall be guilty of an offence.

Limitation of liability

440J.

No person shall be liable in respect of anything done in good faith in the exercise or performance of a power or duty conferred or imposed by or under this Chapter."

Section 5 of the Amendment Act, as as been mentioned, bolsters the penalties prescribed by Section 441 of the Principal Act.

(77) Ibid, p.65.

Section 6 of the Amendment Act, provides for the repeal of Sections 224, 229 to 233 and 314 to 321 of the Principal Act.

Finally, **Section 7 of the Amendment Act** makes provision for its short title and commencement, expressly providing for different dates to be fixed in respect of different provisions of the Act.

5. CONCLUSION

There can be no doubt that the **Companies Amendment Act, 1989** fomented a complete change in the way most involved in the securities business think, behave and reach decisions.

Part of its success in this regard must be attributed to the more considered approach which the draftsmen and legislators of the Act have clearly exhibited on policy issues.

The acid test of the **1989 Amendments** was the response of the powerful stock exchange lobby reported in the Financial Mail of June 30, 1989:

"Judging from the reaction after a talk given at the JSE this week by University of the Witwatersrand law professor Michael Katz, many have yet to assess the effects. Responses from a number of brokers' senior partners canvassed ranged from a view that there will be little practical effect in terms of brokering practices and administrative procedures, to considerable unease about what were still seen as uncertain implications.

Katz cited two reasons why insider trading needs to be sanctioned. One is that when it is not prohibited, this can create a bias against prompt disclosure of information by the directors of a listed company. Another is that insider trading undermines investor confidence in the stock exchange and impairs its performance in raising finance.

Most brokers say they agree. Where there is less agreement, is what should constitute insider trading." (78)

Whilst it was clear that the considerations of policy underlining the amendments enjoyed the endorsement of those at the cutting edge, the last sentence of the report had an ominous ring to it.

In their attempt to fulfil the policy objectives, the Acts' draftsmen had relied heavily on the American treatment of insider trading. This reliance was perhaps made all the more stronger by an eagerness to duplicate the Securities and Exchange Commission. Consequently, it appears that they adopted, in slightly modified form, much of the provisions employed in the United States to regulate dealings in securities.

This had the unfortunate effect of resulting in the enactment of a prohibition on insider trading couched predominately in American phraseology, much of it foreign to our traditional English Law treatment of company law issues.

The definition of insider trading was the provision most affected by the reliance on the American approach and, as alluded to above, became an area where improvement would obviously be required.

In line with the pragmatism which had characterised the approach to the original **1989 Act,** a lot more thought was given to the question of what constitutes insider trading.

(78) Financial Mail; Insider Trading - Stricter times for brokers; June 30, 1989; p.73.

The result was the **Companies Second Amendment Act 69 of 1990** which appeared in Government Gazette No. 12568 dated 29 June 1990. Section 3 of this Act substituted a new **Section 440F** which provided for a revised definition of the crime of insider trading:

"Prohibition of insider trading

440F.

(1) Any person who, whether directly or indirectly, knowingly deals in a security on the basis of unpublished price-sensitive information in respect of that security, shall be guilty of an offence, if such person knows that such information has been obtained:-

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

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

(2) For the purposes of this section:-

(a) *'unpublished price-sensitive information'*, in respect of a security, means information which:-

(i) relates to matters in respect of the internal affairs of a company or its operations, assets, earning power or involvement as offeror or offeree company in an affected transaction or proposed affected transaction;

(ii) is not generally available to the reasonable investor in the relevant markets for that security; and

(iii) would reasonably be expected to affect materially the price of such security if it were generally available;

b) *'generally available'* means available in the sense that such steps have been taken, and such time has elapsed, that it can reasonably be expected that such information as referred to in paragraph (a) is or should be known to such investor as referred to in sub-paragraph (ii) of paragraph (a).

(3) If at criminal proceedings at which an accused is charged with an offence under sub section (1), it is proved that:-

(a) the accused was in possession of unpublished price-sensitive information in respect of the security in question at the time of the alleged commission of the offence; or

(b) unpublished price-sensitive information was obtained in the manner contemplated in sub section (1)(a) or (b),

he or it shall be deemed, unless the contrary is proved, in the case of:-

(i) paragraph (a), to have knowingly dealt in that security on the basis of such information;

(ii) paragraph (b), to have known that such information was so obtained. ..."

The section continues to provide similar measures in respect of civil liability and members' interest in a close corporation.

Furthermore, the section introduces a **Section 440F(6)** which allows the Minister to gazette exemptions to the provisions of the section, with or without conditions, and empowers the revocation or amendment of such exemptions.

Additional sections of the **Companies Second Amendment Act, 1990** provide for the insertion of provisions which further regulate the powers and duties of the Securities Regulation Panel, amend the obligation on certain persons to furnish information, make compulsory the acquisition of the securities of a minority in an affected transaction, and enforce more effectively the rules of the panel.

It can indeed be seen that the **Companies Amendment Act, 1989** provided the impetus needed to effectively address the question of insider trading. As a result of its innovative measures, South African treatment of the issue underwent a fundamental change. This has resulted in the enactment of further provisions designed to ensure that our law in respect of securities regulation is capable of serving the needs of both the business community and society at large.

Commenting on the **1989 Act,** the JSE's Tony Norton said:

"The proposed amendments may not be the perfect solution. But they are a giant step forward." (79)

The **Companies Amendment Act, 1989** can not be said to be a panacea for insider trading. It does however constitute an important milestone in the search for a cure.

(79) Financial Mail; Securities Law - Giant step forward; May 19, 1989; p. 90.

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