The regulation of insider trading on the JSE: A comparative study with Hong Kong

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ABSTRACT

Insider trading on the JSE can be linked, directly or indirectly, to the reputation of the South African financial market. The regulation thereof is essential and a non-negotiable requirement for the successful attraction and retention of investment flows. Inadequacies associated with the regulatory framework regulating insider trading, the onus of proof in a criminal trial and the lack of civil remedies associated with insider trading as a form of market abuse, motivates a critical analysis into the regulatory framework on insider trading in South Africa. The aim of this study is therefore to identify international best practice principles to fill the gap in South Africa's regulatory framework. This gap relates to the practical application and execution of legislative and other instruments in order to combat insider trading as a form of market abuse. A further aim focuses on the simultaneous development of the legislation relating to financial markets in conjunction with developments in the economy. A final aim is to determine whether and how South Africa can improve its current legislative dispensation on insider trading.

In order to arrive at the aim of the study the historical development on the regulation of insider trading is discussed. A critical analysis of the relevant insider trading sections in the *Securities Services Act* 36 of 2004 is compared with the corresponding sections of the *Financial Markets Act* 19 of 2012. A discussion on the roles, duties and authority of the Financial Services Board, the Directorate of Market Abuse and the Enforcement Committee will assist in analysing these organisations' contribution in regulating insider trading in South Africa. A look into the application of other regulatory instruments including the JSE's Code of Conduct is required. In order to determine whether and how South Africa can improve its current legislative dispensation on insider trading, a comparative study is conducted with Hong Kong. It is submitted that the South African regulatory framework on insider trading has to be revised in order to align with international best practice principles and to promote transparency of the JSE, promote investor confidence and ensure justice for all.

Key words: Insider trading, inside information, market abuse, regulatory framework, dealing

OPSOMMING

Die regulering van binnehandel op die JEB: 'n Vergelykende studie met Hong Kong.

Binnehandel op die Johannesburg Effektebeurs kan op 'n direkte of indirekte wyse gekoppel word aan die reputasie van die Suid-Afrikaanse finansiële markte. Die regulering daarvan is kardinaal en nie onderhandelbaar ten einde die suksesvolle verkryging en behoud van investering te verseker. Tekortkominge wat ge-assosieer word met die regulerende raamwerk rondom binnehandel, die bewyslas in 'n kriminele verhoor en die tekort aan siviele remedies vir binnehandel as 'n vorm van 'n mark misbruik, motiveer die kritiese oorsig oor die regulerende raamwerk van binnehandel in Suid-Afrika.

Die oogmerk van die studie is om die internasionale regulerende beginsels te identifiseer ten einde die gaping in die Suid-Afrikaanse regulerende raamwerk te vul. Hierdie sogenaamde gaping hou verband met die praktiese toepassing en uitvoering van die wetgewende en ander instrumente wat binnehandel teë werk. 'n Verdere oogmerk fokus op die gelyktydige ontwikkeling van die wetgewing verbandhoudend tot die finansiële markte in samehang met die ontwikkelings in die ekonomie. Die finale oogmerk van die studie is om vas te stel of Suid-Afrika wel en op watter wyse verbeterings aangebring kan word tot die huidige wetgewende samestelling met betrekking tot binnehandel.

Ten einde die bogenoemde oogmerke te bereik moet die historiese ontwikkeling van die regulering van binnehandel bespreek word. 'n Kritiese bespreking van die relevante binnehandel artikels in die *Securities Services Act* 36 van 2004 (die wet is nie in Afrikaans verorden nie) word vergelyk met die ooreenstemmende artikels van die *Financial Markets Act* 19 of 2012 (die wet is nie in Afrikaans verorden nie). 'n Bespreking rondom die rolle, pligte en outoriteit van die Financial Services Board, die Directorate of Market Abuse en die Enforcement Committee sal behulpsaam wees in die ondersoek verbandhoudend tot hierdie organiesasies se bydraes tot die regulering van binnehandel in Suid-Afrika. 'n Verdere ondersoek tot die JSE se Gedragskode word vereis. Ten einde vas te stel of Suid-Afrika verbeterings moet aanbring tot die huidige

wetgewende samestelling rakende binnehandel moet 'n vergelykende studie met Hong Kong uitgevoer word. Die submissie word gemaak dat die Suid-Afrikaanse binnehandel regulerende raamwerk hersien moet word ten einde internasionale regulerende praktyke te handhaaf in Suid-Afrika. Dit sal bydra tot die deursigtigheid van die JEB, sal investeerders se vertroue in Suid-Afrikaanse markte bevorder en geregtigheid vir almal verseker.

Sleutelwoorde: Binnehandel, binne inligting, mark misbruik, regulerende raamwerk, handel

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LIST OF ABBREVIATIONS

CPI	Consumer Price Index
DMA	Directorate of Market Abuse
FMA	*Financial Markets Act* 19 of 2012
FSB	Financial Services Board
HK$	Hong Kong Dollar
IDT	Insider Dealing Tribunal
IOSCO	International Organisation of Securities Commissions
JSE	Johannesburg Stock Exchange
MMT	Market Misconduct Tribunal
NPA	National Prosecuting Authority
R	Rand
SARB	South African Reserve Bank
SEHK	Stock Exchange of Hong Kong Limited
SENS	Stock Exchange News Service
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance
SRC	Securities Review Committee
SSA	*Security Services Act* 36 of 2004

Chapter 1 Introduction and problem statement

1.1 Introduction

Eradicating the practice of insider trading is essential for the reputation of any financial market and has proven to be a non-negotiable requirement in order to attract and retain investment flows.[1] Insider trading occurs when trades are made based on price sensitive information, relating to a specific security, not yet published by the Johannesburg Stock Exchange News Service (SENS).[2] It becomes a form of market abuse once it negatively influences the efficient working and reputation of any market.[3]

1.2 Research question

To what extent does the South African legal framework on insider trading align with Hong Kong's best practice principles on financial market regulations and to what extent should Hong Kong's best practise principles be adopted in South Africa?

1.3 Historical background

Prior to 1973 insider trading was not prohibited by law. The first prohibition thereof was in section 233 of the *Companies Act* 61 of 1973, which was later replaced by section 440F of the same Act. At that stage insider trading contained only criminal sanctions and had to be proven beyond a reasonable doubt. No other civil remedies were available to individuals prejudiced by insider trading.[4] In order to assist South Africa with the re-integration of its financial market into the international financial market sphere, the *Insider Trading Act* 135 of 1998 replaced Act 61 of 1973.[5] This enactment focused on creating a financial environment conducive to foreign investment.

In 2005 the new *Security Services Act* 36 of 2004 (SSA) replaced the *Insider Trading Act* 135 of 1998. This replacement was motivated by the objectives and ideals of the

1 Chitimira *Regulation of Insider Trading* 2.
2 Loubser 2013 www.jse.co.za 5.
3 Loubser 2013 www.jse.co.za 5.
4 Van Deventer 2013 www.fsb.co.za.
5 Wilson 2011 *http://www.sharenet.co.za* par 6.

new SSA which focused on stabilising the market environment, growing investor confidence and improving financial market efficiency.[6]

International and local financial market developments before and after the global financial crisis and implementation challenges demanded an assessment of the SSA.[7] After this assessment the SSA was found wanting in respect of its alignment with local and international developments and standards, continuously meeting objectives of financial regulation in general, maintaining the integrity of the regulatory framework of the South African financial markets, and effectively mitigating impacts of possible future financial crises.[8] The assessment revealed complex amendments to be made to the SSA, and therefore, inspired by legal certainty and simplicity, the *Financial Markets Act* 19 of 2012 (FMA) repealed the SSA on 1 February 2013.[9]

1.4 Problem statement

The inadequacies of previous legislation regarding the onus of proof in a criminal trial and the lack of civil remedies motivated legislators to fill these legislative gaps by promulgating the SSA.[10] The current problem of insider trading relates to the practical enforcement of legislation and other instruments, such as the Johannesburg Stock Exchange's (JSE) listing requirements, in order to eliminate insider trading. As the South African economy grows in sophistication, the current legislation becomes inadequate due to the absence of simultaneous development of both these variables.[11]

The application and interpretation of Chapter 8 of the SSA, sections 73 to 78 of the *Insider Trading Act* 135 of 1998, section 440 F of the *Companies Act* 61 of 1973, and Chapter 10 on Market Abuse of the FMA will be discussed. A look into the application of other regulatory instruments including the JSE's Code of Conduct is required. In order to determine whether and how South Africa can improve its current legislative dispensation on insider trading, a comparative study is conducted with Hong Kong. Hong Kong is one of the largest financial centres of the world, has the seventh largest

6 Wilson 2011 *http://www.sharenet.co.za.*
7 National Treasury 2012 http://www.treasury.gov.za 11.
8 National Treasury 2012 http://www.treasury.gov.za 11.
9 National Treasury 2012 http://www.treasury.gov.za 12.
10 *Security Services Act* 36 of 2004.
11 National Treasury 2011 http://www.treasury.gov.za 12.

stock exchange and is regarded as a leader in international best practice principles on insider trading.[12] The leading Hong Kong authority which will contribute constructively to the study includes chapter 571 and specifically section 273 of the *Securities and Futures Ordinance* which deals directly with insider trading.

1.5 Scope of the study

This study will be limited to the legislative framework on insider trading in South Africa and specifically the FMA. Legislation in force prior to the enactment of the FMA will be discussed for the purpose of a historical analysis in respect of insider trading. South African legislation on insider trading will be compared to the legislation of Hong Kong. Only the provisions of the FMA and the SSA that are relevant to the topic of the study will be discussed. The JSE Listing Requirements will not be discussed in detail except for the disclosure requirements as outlined in Chapter 3. Space and scope restrictions limit the study to insider trading.

1.6 Aims and objectives of the study

The aim of this study is to identify international best practice principles to fill the gap in South Africa's regulatory framework. This gap relates to the practical application and execution of legislative and other instruments in order to combat insider trading as a form of market abuse. A further aim focuses on the simultaneous development of the legislation relating to financial markets in conjunction with developments in the economy. A final aim is to determine whether and how South Africa can improve its current legislative dispensation on insider trading. By addressing these aims, stability of the South African financial markets and investor confidence may be improved.

The more specific objectives of this study relate to recommending structures incorporating international best practice principles that will enhance enforcement of insider trading laws and other regulatory instruments in South Africa. A further objective focuses on recommending amendments to the FMA. The final objective relates to encouraging practises that can be easily implemented by South African financial markets and individual companies in order to deter acts of insider trading.

12 Leung *Impacts of Insider Trading* 8.

1.7 Research methodology

In order to determine whether the South African regulatory framework adheres to international best practice principles, and in order to make realistic recommendations as to eradicating insider trading, the following research methods will be applied.

The research will be conducted via a literature study of the most significant primary and secondary sources such as statutes, case law, text books, law journals and electronic sources pertaining to the problem as stated on insider trading. Due to the legal comparative nature of the study, a further literature survey of primary and secondary sources of Hong Kong is required.

1.8 Structure of the study

This study consists of five chapters including this chapter. The main focus points of each chapter are as set out below.

Chapter one deals with the introductory remarks as to what insider trading is and outlines the historical background, problem and aim of the study. A brief overview of the research methodology is indicated.

Chapter two provides for an exposition as to why insider trading should be considered as an unethical trade practice. It further discusses whether the regulation of insider trading is desirable and necessary.

Chapter three critically discusses the repealed *Security Services Act* 36 of 2004 in comparison to the newly enacted *Financial Markets Act* 19 of 2012. It looks into the meaning and interpretation of insider trading as a form of market abuse and whether the penalties, defences and criminal and civil sanctions are sufficient.

Chapter four provides a comparative analysis of the regulatory framework regarding insider trading in Hong Kong. It highlights the international best practice principles and determines whether relevant principles of Hong Kong's law should be recommended for inclusion in South Africa's regulatory framework.

Chapter five concludes the study and presents possible recommendations on eliminating the problem of insider trading in South Africa.

Chapter 2 The moral philosophical perspective on insider trading

Insider trading in stock markets is considered as one of the most controversial issues in business ethics.[13] This controversy relates to the question of whether rules and regulations governing insider trading can be drafted to secure an abstract ideal of fairness.

Chapter 2 will focus on discussing several philosophical approaches in determining whether and under which circumstances insider trading can be considered ethical or unethical. Arguments in favour of and against the practice of insider trading will be outlined. A conclusive argument as to which philosophical doctrine applies will expose why insider trading should be regarded as an unethical business practice. This will prove why regulation of insider trading is desirable and necessary.

2.1 Arguments in favour of insider trading

The philosophical foundations supporting insider trading are based on the philosophical approaches of utilitarian ethics and the rights theory.[14] These foundations form the basis of the arguments for insider trading.

Utilitarian ethics can be compartmentalised in either the modern or classic approach.[15] In utilising utilitarian ethics to establish whether insider trading is ethical, the premise is that the action of insider trading is good if the result is for the greater good of the greater majority.[16] This is known as classic utilitarianism. The modern approach can be regarded as a positive total game where the good has to exceed the bad.

In the more eclectic interpretations of utilitarianism in relation to insider trading, additional factors might be taken into account to determine whether insider trading is unethical. This might include whether, for example, a breach of a fiduciary duty towards shareholders or a company has occurred. In equating whether the good outweighs the bad or whether insider trading results in a greater good for the majority, this proposed

13 Barry 1991 *George Mason University Press* 57.
14 McGee 2009 *Journal of Business Ethics* 2.
15 McGee 2009 *Journal of Business Ethics* 2.
16 Yunker 1986 *Review of Social Economy* 80.

fiduciary breach will be included in the equation to determine whether insider trading is ethical. Should this still equate to a positive total, the act of insider trading can be regarded as ethical.

A point of criticism against the utilitarian approach is that a measurement of gains and losses is impossible. Determining whether an inside trade is for the greater good is unfeasible and cannot be measured as a constant.[17] A second point of criticism is that no precise measurement is possible with regard to gains over losses in an instance where a small group of individuals or a few groups benefit from an inside trade whilst a vast majority is harmed by it.[18] The final and strongest criticism against utilitarianism is that it disregards rights. As an inherent and structural weakness of the utilitarian approach, a utilitarian's end justifies the means involved. Whether the good outweighs the bad reigns over an individual's or a group's rights.[19] This good versus bad argument is irrelevant when considering property rights.

Henry Manne[20] suggests in his works that insider trading is a victimless crime.[21] The rights theory questions whether someone's rights have been violated by an act committed.[22] Based on this, rights theorists believe that insider trading should be permitted, even if it is immoral, as long as no one's rights are violated. Supporters of insider trading elect the rights theory as the best viable option to validate the act in pluralist states where the citizenry is not homogeneous, and different standards as to what is ethical and what is not are held by different groups of society.[23]

From the philosophical approaches of utilitarianism and the rights theory flow the arguments for insider trading.

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17 Smart and Williams 1973 *Cambridge University Press* 361.
18 Shaw 1999 *European Journal of International Relations* 444.
19 Frey 1984 *University of Minnesota Press* 68.
20 Henry Manne is a Professor Emeritus of the George Mason University in the United States of America. His research deals with subjects of law and economics.
21 Manne 1966 *Harvard Business Review* 114.
22 McGee 2009 *Journal of Business Ethics* 3.
23 McGee 2009 *Journal of Business Ethics* 3. The Merriam Webster dictionary defines a '"pluralist state"' as a state with people of different social classes, religion and races who form part of the same society but continue to function in respect of their different traditions and interests.

2.1.1 Executive compensation

The argument on executive compensation suggests that the act of insider trading is a form of compensating the executive for his/her entrepreneurial efforts. In the long run it will promote economies of scale within a company as it lowers payroll costs and therefore leads to decline in the total cost to company.[24]

The criticism against this argument is that the rewards are not necessarily tied to performance.[25] Executives might benefit from insider trading and be compensated for their trades even in instances when the company is doing poor and trading at a loss. The very insiders who might have caused the stock in a company to drop in price can gain in income as they sell their stock before stock related information is disseminated to the broad public.[26]

2.1.2 Efficiency argument

This argument links to modern utilitarianism in determining that something is ethical if it increases efficiency.[27] Allowing insiders to trade on exclusive information may cause share prices to move in the right direction leading to more efficient markets as the market will move in the right direction at a faster pace.[28] Traders would have the luxury of trading on inside information immediately as opposed to holding off trades until the information has been disseminated to the broad public. This is considered a-priori reasoning.[29]

The problem with the efficiency argument is that the number of shares that the elite few would be able to trade based on inside information would be too small to have a significant effect on share prices and ultimately the market as a whole.[30] Furthermore efficiency cannot be substituted for ethics. Performing an unethical act with more

24 Manne 1966 *Harvard Business Review* 114.
25 McGee 2009 *Journal of Business Ethics* 4.
26 McGee 2009 *Journal of Business Ethics* 4.
27 Posner 1998 *Aspen Law and Business* 285.
28 Manne 1966 *Harvard Business Review* 117.
29 The Merriam Webster dictionary indicates that ‘a-priori’ reasoning relates to reasoning that is based on a theoretical deduction rather than an empirical analysis.
30 Egger *Uncertainty and Disequilibrium* 365.

efficiency does not constitute ethical behaviour.[31] By substantiating the efficiency argument with the utilitarian approach traders may be blinded to the inherent deficiencies associated with utilitarian ethics. This will lead to incorrect conclusions as to ethical trade behaviour.[32]

The counter argument to the efficiency argument relates to the perception of investors that only insiders can benefit from market activity. This leads to the withdrawal of investors from the market, causing the market to become less liquid and less efficient.[33] Continuous disagreement as to which argument to follow on efficiency is based on the exceptional difficulty in conducting empirical studies. Taking all factors that affect efficiency into account and subsequently assigning the correct weight to each factor seem to be impossible.[34] Starting off with an incorrect premise will result in an incorrect conclusion.

2.1.3 Rights-based argument

It is trite law that property owners can do with their property as they regard fit. This approach can also be regarded as the entitlement theory.[35] The criticism against the rights-based argument is that it is not always clear whose property the information is that is being traded on. If information belongs to a specific entity, the entity is the owner of the information. In some instances the information belongs to different parties at the same time. The ethical problems arise when information is misappropriated. If for example a lawyer dealing with a merger of two companies trade on information attained about the merger, an inside trade would have been committed. A suggestion to resolving the rights-based problem to insider trading, is to regard inside information as property, allowing the owners of the information to trade on their rightfully owned property.[36]

31 Egger *Uncertainty and Disequilibrium* 366.
32 Machan 1996 *Public Affairs Quarterly* 135.
33 McGee 2009 *Journal of Business Ethics* 6.
34 McGee 2009 *Journal of Business Ethics* 6.
35 Nozick *Anarchy, State and Utopia* 40.
36 Morgan 1987 *Ohio State Law Journal* 100.

2.2 Arguments against insider trading

Disadvantages associated with insider trading in its illegal form and as a supposed legalised market mechanism promote inefficiency in the functioning of a free economic market; negatively impact on the privacy of parties and lower investor confidence in an economic market, thereby destroying competition.[37] The arguments against insider trading are as explained in the following paragraphs.

2.2.1 The labour theory of value

The economists Karl Marx and Adam Smith promoted the theory that a price should be allocated to a product in accordance with the quantity of labour needed to produce the product.[38] Supporters of the labour theory of value view insider trading as an unfair trade practice and opine that traders shouldn't be able to make money from little effort. The problem with the labour theory of value is that the value of a product is not solely dependent on the quantity of labour input but on the amount consumers are willing to pay for it.[39] It is therefore submitted that the labour theory of value is irrelevant in utilising it as a benchmark for the morality of insider trading.

2.2.2 Insider trading is wrong

This argument is ruled by the logic of appropriateness.[40] The rules of appropriate action determine human behaviour. People adhere to rules because they are expected and ingrained into institutions, and as people form part of a political and social society within which certain behaviour is expected.[41] Based on the logic of appropriateness insider trading is considered wrong and as such unethical.

37 Werhane 1989 *Journal Of Business Ethics* 841.
38 McGee 2009 *Journal of Business Ethics* 7.
39 McGee 2009 *Journal of Business Ethics* 7.
40 March & Olsen 2004 *ARENA Working Paper* 16.
41 March & Olsen 2004 *ARENA Working Paper* 17.

2.2.3 Fairness

Disuse is caused in an economic market where insider trading unfairly shifts the risk in the favour of insiders.[42] In an attempt to clarify the concept of fairness it relies on the basis of the standard deontological approach. An act can only be regarded as morally justifiable if it encumbers respect for the rights and dignity of the people it affects and not only for the utility the act produces. A trade is considered fair if insiders and outsiders are in an equal position and if one group doesn't envy the position of the other.[43]

2.2.4 Fiduciary duty

The argument in relation to fiduciary duty is the strongest argument against insider trading.[44] The underlying concept related to the fiduciary duty argument is that directors and officers of a company have a fiduciary duty towards shareholders to fully disclose noteworthy information.[45] This theory posits that directors who are guilty of insider trading have an obligation towards shareholders of a company regarding increasing the interests of a company. The director/insider trader acts in breach of this duty when trades are made based on inside information in order to gain a profit or circumvent a loss. In the *Pather* case the court held that one of the elements to be taken into account in calculating an administrative penalty to be imposed by the FSB's Enforcement Committee for an act of insider trading, was whether the appellant in the matter had failed to comply with a fiduciary duty towards the shareholders of the company *in casu*.[46] Section 76 of the *Companies Act* 71 of 2008 places a statutory duty on directors of a company to act in good faith, in a reasonable manner and honestly. Their conduct should always be in the best interest of the company and its shareholders and the directors should always instil a higher level of due diligence when acting within their capacity as directors of the company. In terms of section 75 of the *Companies Act* 71 of

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42 Cho & Shaub 1991 *Business and Professional Ethics Journal* 8. The Merriam Webster dictionary indicates "disutility" to include situations of counter productivity or activities with harmful effects.

43 McGee 2009 *Journal of Business Ethics* 11.

44 Moore 1990 *Journal of Business Ethics* 175.

45 O'Hara 2001 *International Journal of Social Economics* 1040.

46 *Pather v Financial Services Board* 2014 JDR 0528 (GNP) 56. In the *Pather* case the appellant appealed against an order by the Enforcement Committee to pay an administrative penalty as it was found guilty of insider trading in terms of s 73 and s 74 of the SSA. The appeal was based on the *ultra vires* nature of the order as granted by the Enforcement Committee.

2008 a director can incur liability in his personal capacity if he/she acts in a fraudulent manner. Section 75 of the *Companies Act* 71 of 2008 makes provision for a duty of disclosure by a director of a company towards shareholders in respect of direct or indirect interests he/she may have in a contract concluded on behalf of the company. This forms the basis of the fiduciary duty a director has towards shareholders or members of a company. This duty of disclosure is also stipulated in section 3.4 of the JSE Listing Requirements, but has not been statutorily provided for in terms of the FMA.[47] The section 3.4 disclosure duty is based on the fiduciary duty of corporate law.[48] In publicly announcing price sensitive information via the SENS network of the JSE, the fiduciary duty of directors and officers are fulfilled and all relevant investors are placed in an equal position to competitively partake in market activities and contribute to the economic efficiency of the South African economy. This will contribute to reaching the statutory market objectives as set out in the FMA, namely creating a transparent market environment and building local and international investor confidence.

2.2.5 Misappropriation

Insider trading is immoral and unethical if traders trade on information they are not legally entitled to, even when such trades meet the requirements related to utilitarian ethics.[49] The misappropriation theory holds that insider trading is unethical if a third party utilises inside information, obtained through the natural course of its business, in such a way to infringe on the owner of the information's property rights. Criticism against the misappropriation theory is that confusion exists regarding instances where insiders, tippees and other professionals have to refrain from using inside information for their own gain.[50]

2.3 Conclusion

In considering the different philosophical approaches to determine whether insider trading should be regarded as ethical or unethical, it is submitted that insider trading is

47 S 3.4 of the JSE Listing Requirements in respect of the disclosure requirement will be discussed in more detail in Chapter 3.
48 Wang *Insider Trading* 300.
49 McGee 2009 *Journal of Business Ethics* 13.
50 McGee 2009 *Journal of Business Ethics* 14. The Financial Dictionary indicates that a 'tippee' can be considered to be a person who receives inside information.

unethical. The utilitarian approach includes insoluble structural deficiencies and cannot be regarded as a good device to analyse and confirm insider trading as a positive market mechanism. Insider trading should be regarded as a fraudulent act which infringes on the property rights of owners of inside information. This form of market abuse, whether in its current illegal form in South Africa or as a legalised market instrument, infringes on the privacy of relevant traders, negatively influences the transparency of the marketplace, and corrupts investor confidence. This questions the market's very reason for existence. It is therefore submitted that insider trading should be regarded as a moral and legal wrong and the regulation thereof is desirable and necessary. The following chapter will focus on critically analysing the current regulation of insider trading in South Africa.

Chapter 3 South African statutory framework and case law on insider trading

3.1 Introduction

Usage of privileged information in order to gain a profit or circumvent a loss and ultimately causing a disadvantage to other market participants is considered legally reprehensible.[51] The main purpose of insider trading regulations is to enhance investor confidence in a certain jurisdiction's financial market and to improve the efficient functioning thereof.[52] From 2004 the SSA regulated insider trading and came into effect on 1 February 2005. It consolidated the provisions of the *Stock Exchange Control Act*,[53] the *Financial Markets Control Act*,[54] the *Custody and Administration of Securities Act*[55] and the *Insider Trading Act*[56] to one. The FMA repealed the SSA and now governs the regulation of the market abuse known as insider trading as well as the criminal and civil liabilities associated therewith.

The purpose of this chapter is to critically analyse the newly enacted FMA against the backdrop of the repealed SSA. This analysis seeks to critically interrogate the FMA and ultimately expose deficiencies in respect of the current insider trading regulatory framework. The investigation will assist in proposing new practical measures to combat insider trading.

The discussion will forthwith include an overview of key concepts and definitions pertaining to insider trading; insider trading as a criminal offence and the civil liability associated therewith; the defences to insider trading, and lastly the enforcement of provisions in the regulation of insider trading.

51 Posthumus '"Insider Trading'" 215.
52 Posthumus '"Insider Trading'" 216.
53 *Stock Exchange Control Act* 1 of 1985.
54 *Financial Markets Control Act* 55 of 1989.
55 *Custody and Administration of Securities Act* 85 of 1992.
56 *Insider Trading Act* 135 of 1998.

Definitions and concepts as outlined by legislation

3.1.1 Insider trading, insiders and inside information as defined by the SSA and the FMA

In terms of section 78 of the FMA and section 73 of the SSA the offence of insider trading is committed by an insider when trades are affected in terms of securities listed on a regulated market which were motivated by inside information. The inside information will, if known by the broad public, have an effect on the price of the shares traded on. The trade has to be affected by the insider directly or through an agent for his or her or a third party's account.[57]

Prior to the enforcement of the SSA an insider could only be a natural person,[58] after which a partnership and a trust have been included in terms of section 72 of the SSA. This inclusion is now reflected in section 77 of the FMA. An "insider" is considered to be a:

> person who has inside information through:
> (a)(i) being a director, employee or shareholder of an issuer of securities listed on a regulated market to which the inside information relates; or
> (a)(ii) having access to such information by virtue of employment, office or profession; or
> (b) where such person knows that the direct or indirect source of the information was a person contemplated in paragraph (a).[59]

Insiders can be categorised into two different groups, namely primary and secondary insiders.[60] The definition of an insider provides for primary insiders while secondary insiders are regarded as tippees.[61] A fiduciary relationship exists between an insider and the company in which his/her employment is vested. Even though a company is

57 S 78 of the *Financial Markets Act* 19 of 2012 and s 73 of the *Securities Services Act* 36 of 2004.
58 S 440F of the *Companies Act* 1973 and the *Insider Trading Act* 135 of 1998 only provided for insiders to be natural persons.
59 S 77 of the *Financial Markets Act* 19 of 2012 and s 72 of the *Securities Services Act* 36 of 2004.
60 Chitimira *The Regulation of Insider Trading* 5.
61 Jooste 2006 *The South African Law Journal* 438.

excluded from the definition of an insider, it can be considered as such when it repurchases the company's own shares.[62]

"Inside information" is defined as:

> specific or precise information which has not been made public and which
> (a) is obtained or learned as an insider, and
> (b) which if it were made public would be likely to have a material effect on the price or value of any security listed on a regulated market.[63]

Only information considered as correct and factual and which does not fall within the public domain can be regarded as inside information.[64] Section 79 of the FMA and section 74 of the SSA elucidate what can be regarded as information falling within the public domain.[65]

The element of knowledge is required to generate civil and criminal liability in terms of the respective sections 78 and 82 of the FMA as well as sections 73 and 77 of the SSA. These sections deal with the act of insider trading and the liability associated therewith. The Financial Services Board (FSB) or the prosecuting authorities, who investigate insider trading cases, will therefore have to prove that the insider, in addition to trading in listed securities, knew that the information traded on was inside information.[66] An obvious difficulty arises in determining whether a person had knowledge regarding his/her trades made, based on inside information. The person had to understand the material and specific nature of the information.
The abovementioned concepts will assist in creating a better understanding of the following discussed sections. The next part of the discussion will focus on explaining the market abuse of insider trading as a criminal offence and the penalties associated therewith.

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62 Posthumus '"Insider Trading'" 217.
63 S 77 of the *Financial Markets Act* 19 of 2012 and s 72 of the *Securities Services Act* 36 of 2004.
64 Chitimira *The Regulation of Insider Trading* 6.
65 S 79 of the FMA states that inside information falling within the public domain is information that has been published in accordance with the rules of the regulated market (SENS Network of the JSE in this regard); information contained in public records of the relevant company; information that can be easily acquired by regular investors in securities and information that has been made public.
66 Jooste 2006 *The South African Law Journal* 442.

3.2 Outlawing insider trading as a criminal offence and penalties

Insider trading is outlined as an offence (in respect of both criminal and civil liability) in terms of section 73 of the SSA and section 78 of the new FMA.[67] Four insider trading offences existed under section 73 of the SSA, which indicated that a person would be guilty of the offence of insider trading in any of the following circumstances: a) If they dealt in securities for their own account while being in possession of inside information; b) if they dealt in securities on behalf of a third party while being in possession of inside information; c) if they disclosed any of the inside information they were in possession of to a third party, and d) if they encouraged or discouraged a third party to deal in securities with knowledge of the fact that the trades were made based on inside information.[68]

With the repeal of the SSA, section 78 of the FMA now provides for a fifth insider trading offence. This section mainly retains the provisions as set out in section 73 of the SSA with slight amendments.[69] Section 78 now extends liability to offenders who executed an offending trade on behalf of a third party while suspecting that the third party was an insider.[70]

3.2.1 Dealing on personal account or on behalf of another person

Section 78(1)(a) and section 78(2)(a) prohibit the offence of insider trading if securities are dealt with for someone's personal account or for another person's benefit and the trades are made based on inside information.[71]

The SSA excluded the definition of "dealing" from the act and no provision has been made for such a definition in the FMA.[72] Dealing includes the act of selling or buying of

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67 S 73 of the *Securities Services Act* 36 of 2004 and S 78 of the *Financial Markets Act* 19 of 2012.

68 S 73 of the *Securities Services Act* 36 of 2004.

69 Chitimira *The Regulation of Insider Trading* 80.

70 S 78(3) of the *Financial Markets Act* 19 0f 2012.

71 S 78(1)(a) An insider who knows that he or she has inside information and who deals directly or indirectly or through an agent for his or her own account in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it, commits an offence. S78(2)(a) An insider who knows that he or she has inside information and who deals, directly or indirectly or through an agent for any other person in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it, commits an offence.

listed securities or encouraging a sale thereof.[73] In order to evade confusion or contravention of section 78 of the FMA an amendment is called for to include the definition of "dealing". The definition of "deal" remains broad and vague and it is unclear as to whether "dealing" includes subscribing for shares. There is no justification for the current exclusion of the definition of "dealing".

The activity of dealing in securities pertains to securities listed on a regulated market such as the JSE.[74] The term "regulated market" is defined as:

> any market, domestic or foreign, which is regulated in terms of the laws of the country in which the market conducts business as a market for dealing in securities listed on that market.[75]

The criminal offence of insider trading can be committed on either the JSE (the domestic regulated market) or any foreign regulated market such as the Hong Kong Stock Exchange.[76] The FMA therefore has extra-territorial application.[77] The FSB has initiated co-operation agreements with foreign regulators of foreign regulated markets.[78] This will empower the FSB to take action against offenders who have to be held criminally liable for insider trading on foreign regulated markets.

An offender can be held liable for insider trading where a territorial link exists between the offender and the jurisdictional area of South Africa.[79] Where the offender deals based on any inside information on any regulated market or through a broker on a foreign regulated market, liability will be incurred under section 78 of the FMA.[80] While this extra-territorial link creates the impression that

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72 Jooste 2006 *The South African Law Journal* 445.
73 Loubser 2006 http://www.jse.co.za.
74 Posthumus "Insider Trading" 219.
75 S 77 of the *Financial Markets Act* 19 of 2012.
76 Chitimira *The Regulation of Insider Trading* 80.
77 Chitimira *A Historical Overview of Market Abuse Prohibition in the United Kingdom* 55. The extra-territorial application of the FMA's sections on insider trading are therefore applicable to securities listed locally on the JSE as well as foreign regulated markets and apply to both natural as well as juristic persons.
78 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.
79 Jooste 2006 *The South African Law Journal* 446. This situation doesn't require that the offender to be domiciled in South Africa nor to be a South African citizen.
80 Chitimira *The Regulation of Insider Trading* 81.

proactive steps are being taken to curb insider trading, it has not been fully utilised due to limited resources.[81] The FMA endeavours in this regard to protect the South African financial market, but the granting of such an open-ended regulatory framework is unnecessary, too broad and the financial burden it encompasses is unwarranted.[82] A more limited approach is called for. The legislature should introduce practical enforcement measures to discourage insider trading. The FMA does not provide for instances in which the offence of insider trading is committed in unregulated markets in respect of example money market instruments such as derivatives.[83]

Section 78(1)(a) of the FMA provides for instances in which insiders deal 'directly or indirectly' or 'through an agent'.[84] The development of extending criminal liability to insiders who deal through agents is constructive, but no concise definition of who can be regarded as an agent for purposes of the insider trading offence exists.[85] In order to limit the risk and abuse of inside information, the word 'agent' should be defined for purposes of this section. The exclusion of dealing through an agent on someone else's account in terms of section 78(2)(a) is incongruous as it is a definite possibility.

It is submitted that uncertainties still remain in respect of section 78(1)(a) and section 78(2)(a) of the FMA. It is concluded that many of the defects of the corresponding section 73(1)(a) and section 73(2)(a) have been carried forward from the SSA to the FMA.

3.2.2 Disclosure of inside information to another

A person commits a criminal offence in terms of section 78(4)(a) of the FMA when disclosing inside information with the knowledge of the inside nature of the information.[86] This section reflects section 73(3)(a) of the SSA. Liability in terms of

81 Loubser 2006 http://www.jse.co.za.
82 Jooste 2006 *The South African Law Journal* 453.
83 Loubser 2006 http://www.jse.co.za.
84 S 78(1)(a) of the *Financial Markets Act* 19 of 2012.
85 Chitimira *The Regulation of Insider Trading* 80.
86 S 78(4)(a) An insider who knows that he or she has inside information and who discloses the inside information to another person, commits an offence.

section 78(4)(a) is extended to juristic persons but not to any agents acting on their behalf.[87]

An unwarranted omission occurs from section 78(4) of the FMA in that it does not mandate a duty of disclosure of transactions by insiders in respect of securities and instruments issued by their companies.[88] Imposing a statutory duty on insiders to disclose their inside information on an equal access basis to all relevant stakeholders has three advantages.[89] It would dissuade insiders from committing insider trading, it would assist the FSB with enforcing the trading ban as the trades of the insiders would be of public record, and it would increase the information on which spectrum market analysts can rely to base their economic forecasts on.[90]

An additional duty of disclosure of price-sensitive information by companies in respect of the securities they trade is required. This disclosure will assist in eliminating the material nature of the non-public inside information and will reduce the risk of inside trades occurring.[91]

Section 3.4 of the JSE Listing Requirements sets out provisions relating to material price-sensitive information and provides for a general obligation of disclosure in respect thereof. [92] Price-sensitive information may only be disseminated through the SENS network, and the JSE only acknowledges a public announcement published on SENS.[93]

Section 3.4(a) indicates that a company has immediately to issue price-sensitive information on SENS as soon as it has become apparent that the information will affect the reference price of the companies' listed securities. Section 3.4(b) of the JSE Listing Requirements specifically provides for disclosure of trading statements. All listed companies trading in securities on the JSE have to adhere to the JSE Listing Requirements in respect of disclosure as provided for in section 3.4(b)(i) to

87 Chitimira *The Regulation of Insider Trading* 82.
88 Jooste 2006 *The South African Law Journal* 452.
89 Jooste 2006 *The South African Law Journal* 452.
90 Chitimira *The Regulation of Insider Trading* 84.
91 Jooste 2006 *The South African Law Journal* 453.
92 S 3.4 of the JSE Listing Requirements. Loubser 2006 http://www.jse.co.za.
93 'General obligation of disclosure' of the JSE Listing Requirements. http://www.jse.co.za 9.

section 3.4(b)(vi).[94] In fulfilling these requirements, companies can only publish price-sensitive information if: a reasonable degree of certainty exists that the financial results to be published differ at least 20% (twenty percent) from the previously published results;[95] the directors and the company's executives decided on the reasonability in respect of the information to be published, independent of the JSE;[96] and if the information published is accurate.[97]

Sections 3.5 to 3.8 encompass the provisions relating to confidential price-sensitive information. No confidential price-sensitive information may be released to any agent, the media or third party unless published and validated in terms of schedule 19 of the JSE Listing Requirements.[98] Furthermore the confidential price-sensitive information may only be conveyed to relevant government departments, the South African Reserve Bank (SARB), and the FSB in the strictest confidence.[99]

In instances where the confidentiality of the confidential price-sensitive information cannot be maintained, cautionary announcements have to be issued by the company to which the information relates.[100] Companies who fail to adhere to the JSE Listing Requirements might be suspended from the JSE or have their securities ceased or postponed.[101]

Even though the JSE Listing Requirements provide for a duty of disclosure, a statutory duty with suitable penalties is still called for.[102] The duty of disclosure is one of the fundamental provisions included in statutes in well-respected

94 Loubser 2012 http://www.jse.co.za.
95 S 3.4(b)(i) of the JSE Listing Requirements http://www.jse.co.za.
96 S 3.4(b)(ii) of the JSE Listing Requirements http://www.jse.co.za.
97 S 3.4(b)(iii) and (iv) of the JSE Listing Requirements http://www.jse.co.za. These sections also relate to the procedures to be followed during and after the dissemination of the price-sensitive information.
98 Schedule 19 of the JSE Listing Requirements http://www.jse.co.za.
99 S 3.6-3.8 of the JSE Listing Requirements http://www.jse.co.za.
100 S 3.9 of the JSE Listing Requirements http://www.jse.co.za.
101 S 3.23 of the JSE Listing Requirements http://www.jse.co.za.
102 S 3 of the JSE Listing Requirements. Loubser 2006 http://www.jse.co.za. In 2004 an investigation was concluded in respect of Telkom Company Limited shares where price-sensitive information was disclosed in an inappropriate manner. The Elephant Consortium group initiated an investigation in secret shareholders' trades who purchased shares of R9 billion in order to cede Telkom shares in advance and ultimately gain financially. The inadequacies of s 73(3)(a) of the SSA failed to prove liability on any of the insiders.

jurisdictions such as the United States, United Kingdom and Hong Kong.[103] The unjustified omission from South African legislation and the current FMA contributes to a warped sense of protection of investors and the integrity of the market.

3.2.3 Encouraging and discouraging to deal

A person can be held criminally liable in terms of section 78(5) of the FMA if he/she, with the knowledge of inside information, encourages, discourages or causes another to deal in respect of securities as listed on a regulated market, such as the JSE.[104] This criminal offence is as described in section 73(4) of the SSA. In terms of section 78(5) of the FMA, the practice of tipping has been outlawed. In this regard the tipper should have knowledge of the inside nature of the information and can therefore plead ignorance in order to evade liability.[105]

In considering the *Insider Trading Act,* the SSA and now the FMA, a person who is encouraged or discouraged to deal without the knowledge of the inside nature of the information is not guilty of a criminal offence (nor does it impose civil liability).[106] It is unclear why a person who trades on an encouragement or discouragement by a third party, regardless of not having knowledge of the root of the information fed to him/her by the encourager/discourager, should not be guilty of an offence. In this regard the legislature has failed in its ultimate goal of combating the market abuse of insider trading.

3.2.4 Criminal liability

Criminal liability is incurred when section 78 of the FMA is contravened.[107] The penalty for the offence of insider trading, in terms of section 115 of the FMA, is limited to a maximum of R50 million and/or 10 years imprisonment.[108] The historical development of the South African insider trading legislation shows that the criminal sanctions associated with market abuse have increased from R2

103 Loubser 2006 http://www.jse.co.za.
104 S 78(5) of the *Financial Markets Act.*
105 Chitimira *The Regulation of Insider Trading* 83.
106 Jooste 2006 *The South African Law Journal* 452.
107 S 78 of the *Financial Markets Act* 19 of 2012.
108 S 115 of the *Financial Markets Act* 19 of 2012.

million to a maximum penalty of R50 million.[109] Large profits, in certain instances, outweigh the penalty of a fine or the possibility of imprisonment.[110] Until lately there have been no successful imprisonments and very few fines imposed for insider trading.[111] The largest fine as imposed by the Enforcement Committee of the FSB has been R2,5 million as indicated in the Enforcement Committee Report of *The Directorate of Market Abuse v Assore Limited*.[112] The onus of proving the offence of insider trading beyond reasonable doubt contributes to this low success rate.[113] The fines imposed in terms of the FMA are all payable to the FSB.[114]

3.3 Civil liability

Section 82 of the FMA provides for the civil liability resulting from insider trading.[115] This section is, as section 77 of the SSA, safe for the provision of the new section 82(3) of the FMA.[116] The same shortfalls that appear in section 77 of the SSA have been carried forward to section 82 of the FMA.[117] Section 82(1) of the FMA imposes a civil liability upon a person if sections 78(1) to 78(3) have been contravened.[118] In terms of these sections[119] an administrative penalty[120] can be imposed on a person who, based on the knowledge of inside information or the knowledge that the information received was from an insider, deals directly, indirectly or through an agent in listed securities on the JSE, in relation to the inside information,[121] for his or her personal account or for a third party.

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109 Wilson 2011 http://www.sharenet.co.za 34.
110 Wilson 2011 http://www.sharenet.co.za 34.
111 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za 12.
112 *The Directorate of Market Abuse v Assore Limited* 08/2008 par 2 In the *Assore Limited*-case the respondent (Assore Limited) acted in contravention of s 73 and s 74 of the SSA in committing the act of insider trading. The Chairperson of the respondent avoided a loss in profits by selling shares of the company prior to publishing price sensitive information via SENS. The Enforcement Committee ordered that a penalty of R2,5 million be paid by the respondent to the FSB.
113 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za 12.
114 Posthumus "Insider Trading" 219.
115 S 82 of the *Financial Markets Act* 19 of 2012.
116 S 77 of the *Securities Services Act* 36 of 2004.
117 Chitimira *The Regulation of Insider Trading* 88.
118 S 82(1) of the *Financial Markets Act* 19 of 2012.
119 S 78(1)-S 78(3) and S 82(1) of the *Financial Markets Act* 19 of 2012.
120 S 82(1) of the *Financial Markets Act* 19 of 2012.
121 Or the likelihood that the deal will be affected by the inside information. S 78(1) to S 78(3) of the *Financial Markets Act* 19 of 2012.

Section 82(1)(a) to (d) specifies the administrative penalties an insider can be held liable for as determined by a competent court.[122] Should the insider fail to rely on any of the defences as provided for in terms of section 82 of the FMA, civil liability will be incurred equivalent to an amount not exceeding the profit associated with the insider dealing or the loss avoided.[123] This profit-/loss-based penalty is based on the fact that, had the unwarranted inside trade not occurred, the insider wouldn't have profited from the deal or avoided the loss.[124]

An administrative sanction may furthermore not exceed an amount of up to R1 million, subject to the Consumer Price Index (CPI), in addition to three times the amount as indicated in section 82(1)(a) of the FMA.[125] Interest and the cost of suit as determined by the Enforcement Committee of the FSB are also included in the calculation of the administrative penalty.[126] The problem with the current and previous sections in respect of interest relates to the calculation thereof. The origin of the capital amount and the period for calculation are not clearly specified.[127] The legislature has to amend section 82 to incorporate provisions pertaining to the calculation of the interest. The FSB has a preferential claim to the amounts as stipulated in section 82 of the FMA. Only after the FSB has been reimbursed for all costs, including investigation costs associated with the investigation into a possible inside trade by a person, may a prejudiced person, who has proven a claim against the insider, be compensated.[128]

Section 82(2) of the FMA imposes a liability on an insider who has acted in contravention of sections 78(4) and 78(5) of the FMA.[129] By enacting the provisions as set out in section 82(2), an administrative penalty can be imposed on an insider who has disclosed inside information or who has encouraged, discouraged or caused another to deal, following on the knowledge of the price sensitive nature of the information.[130] The same administrative penalties are enforced as set out in sections 82(1)(a) to (d) of the FMA in conjunction with section 82(2)(e), all of which provide for

122 S 82(1)(a) to (d) of the *Financial Markets Act* 19 of 2012.
123 S 82(1)(a) of the *Financial Markets Act* 19 of 2012.
124 Chitimira *The Regulation of Insider Trading* 89.
125 S 82(1)(b) of the *Financial Markets Act* 19 f 2012.
126 S 82(1)(c) and (d) of the *Financial Markets Act* 19 of 2012 The role and functioning of the Enforcement Committee and the FSB are discussed below..
127 Jooste 2006 *The South African Law Journal* 456.
128 Whiting 2005 *Responsa Meridiana* 116-117.
129 S 82(2) of the *Financial Markets Act* 19 of 2012.
130 S 82(2) of the *Financial Markets Act* 19 of 2012. S 82(2) is subject to S 78(4) and S 78(5) of the *Financial Markets Act* 19 of 2012.

the insider to pay an administrative penalty equivalent to the commission received for the aforementioned disclosure, encouragement or discouragement.[131] The shortfall in the FMA in respect of this provision is that it does not fully provide for practical steps companies can follow to lawfully disclose price sensitive information to third parties, such as investment analysts, without committing the offence of insider trading.[132]

In contrast with section 77(4) of the SSA, section 82(2) of the FMA now includes discouragement as an offence and holds a person civilly liable in such instances.[133] This discouragement can be as detrimental, in terms of the FMA, as an encouragement to deal based on price sensitive information.[134] Discouragement of one person to another on the basis of knowledge of inside information was previously omitted from section 77(4) of the SSA.[135] This shows a positive development in the regulatory framework in respect of insider trading.

Section 82(3) of the FMA imposes a joint and several liability on "the other person".[136] If for example an insider is held liable for a R1 million administrative penalty, "the other person" can be held liable for another R1 million administrative penalty. The insider would incur the sole responsibility in paying his/her R1 million to the FSB. The FSB can then extract the other R1 million from either the insider or "the other person", or from both. This results in an odd double claim by the FSB for one act of insider trading. The objective of the legislature, in this regard, might have been to ensure that the FSB has a joint and several claim against both the insider and "the other person". The current wording of this section is however vague and confusing.[137]

131 S 82(2)(e) of the *Financial Markets Act* 19 of 2012.
132 Chitimira *The Regulation of Insider Trading* 90. The JSE Listing Requirements provides for a limited degree of practical guidelines in respect of corporate disclosure of inside information. This however does not suffice as a statutory guideline is required and has to be incorporated into the FMA by the legislature.
133 S 82(2)(e) of the *Financial Markets Act* 19 of 2012.
134 The King Task Group into the Insider Trading Legislation Committee of 1995 5-7.
135 S 77(4) of the *Securities Services Act* 36 of 2004.
136 S 78 of the *Financial Markets Act* 19 0f 2012 refers to 'the other person' in respect of agents or brokers who act on behalf of an insider or who is responsible for the discouragement, encouragement or disclosure of inside information. S 82(3) of the FMA is subject to s 78 of the FMA.
137 Jooste 2006 *The South African Law Journal* 455.

3.4 Defences to insider trading

The defences associated with insider trading are outlined in section 78 of the FMA and are based on the defences of section 73 of the SSA.[138] Section 78(1)(b) of the FMA outlines the defences associated with an insider who dealt for his/her own account.[139] These defences have to be proven on a balance of probabilities.[140]

The first defence states that the insider has to have acted in pursuit of a transaction of which all the parties to the transaction had equal access to the same inside information;[141] that trading was limited to the equal accessed parties[142] and that the trade was not motivated by the potential benefit in securing a positive exposure to listed securities affected by a movement in price.[143]

The court stated in *S v Western Areas & Others* that there has to exist a presupposition of lawful conduct on the part of the supposed insider in order to pursue the conclusion of a transaction.[144] The rationale of this defence, as outlined in the new FMA, the previous SSA and *Insider Trading Act*,[145] has been debated and is difficult to understand.[146] The irrationality occurs due to the fact that mergers and take-overs are excluded under this defence as they are regulated by the *Securities Regulation Code on Take-Overs and Mergers.*[147] The supposition exists that the defence was created for an acquirer of securities in a compulsory acquisition of a minor nature in an affected transaction.[148]

An insider has a second available defence in terms of section 78(1)(b)(i) of the FMA. The insider has to prove on a balance of probabilities that the instruction to deal preceded becoming an insider and that the instruction was in no way altered after

138 S 78 of the *Financial Services Act* 19 of 2012 and s 73 of the *Securities Services Act* 36 of 2004.
139 S 78(1)(b) of the *Financial Markets Act* 19 of 2012.
140 S 78(1)(b) of the *Financial Markets Act* 19 of 2012.
141 S 78(1)(b)(ii)(aa) of the *Financial Markets Act* 19 of 2012.
142 S 78(1)(b)(ii)(bb) of the *Financial Markets Act* 19 of 2012.
143 S 78(1)(b)(ii)(cc) of the *Financial Markets Act* 19 of 2012.
144 *S v Western Areas & Others* 2004 (4) SA 591 (W) at par 606.
145 S 78(1)((b)(ii) of the *Financial Markets Act* 19 of 2012; s 73(1)(b) of the *Securities Services Act* 36 of 2004 and s 4 of the *Insider Trading Act* 135 of 1998.
146 Whiting 2005 *Responsa Meridiana* 118.
147 The *Securities Regulation Code on Take-Overs and Mergers* is established in terms of s 196 of the *Companies Act* 71 of 2008.
148 Whiting 2005 *Responsa Meridiana* 119.

having become an insider.[149] The rationale of this defence is that the insider would have dealt in the securities in the exact same way regardless of the inside information. The insider was not incited to deal based on inside information.[150] This indicates that the offence would not be committed in the first place and that the element of *mens rea* would not be present.[151] Legislative intervention is called for as it is still not clear as to whether *mens rea* is a definite prerequisite for liability.[152]

Criminal and civil liability can be evaded in instances when another person deals on behalf of the insider.[153] The defences for the other person are as set out in section 78(2)(b) of the FMA.[154] The two defences as set out above in respect of the insider acting in pursuit of the completion of a transaction and the instruction to deal preceding becoming an insider apply in this instance as well.[155] A further defence is outlined in section 78(2)(b)(i) of the FMA and provides for instances of the insider regarded as an authorised user, if he/she acted on explicit instruction from his/her client, and did not have the knowledge of the fact that the client was an insider. This defence previously applied to any person who acted on behalf of the insider but now it is limited to only authorised users.[156] The defence is now more limited in its application.

A defence is provided for the disclosure offence as portrayed in section 78(4)(a) of the FMA. An insider can evade liability if proven, on a balance of probabilities, that he/she disclosed the inside information as part of the performance of his/her functions of employment or profession.[157] The fact that the information is inside information has to be disclosed at the same time.

No defences are provided for the encouragement or discouragement offences in terms of section 78(5) of the FMA. This indicates that a harsher position is held by the

149 S 78(1)(b)(i) of the *Financial Markets Act* 19 2012.
150 Jooste 2006 *The South African Law Journal* 446.
151 Jooste 2006 *The South African Law Journal* 447.
152 Jooste 2006 *The South African Law Journal* 447 The concept of *mens rea* can be regarded as the criminal intent of the insider when committing the act of inside trading.
153 S 78(2)(a) of the *Financial Markets Act* 19 of 2012 outlines the offence of insider trading committed by one person on behalf of another.
154 S 73(2)(b) of the *Securities Services Act* 36 of 2004 outlines the exact same defences as in S 78(2)(b) of the FMA.
155 S 78(2)(b)(ii) and s 78(2)(b)(iii) of the *Financial Markets Act* 19 of 2012.
156 Whiting 2005 *Responsa Meridiana* 115. An authorised user is furthermore defined in section 1 of the FMA to be a person authorised by a licensed exchange, such as the JSE, to perform a security service in terms of the exchange rules.
157 S 78(4)(b) of the *Financial Markets Act* 19 of 2012.

legislature in this regard, and no leniency is awarded to persons who might have encouraged or discouraged a trade based on inside information.[158]

A final defence which the legislature has omitted from the FMA is the Chinese Wall defence. The goal of a Chinese Wall defence is to physically and operationally segregate the functions of a bigger, multifunctional company.[159] This segregation should prevent price-sensitive information from flowing freely between the different departments of the company.[160] It could for example include the obstruction in flow of non-public price-sensitive information from an investment banking department to a brokers section.

3.5 Enforcement of provisions in regulation of insider trading

In this part of the discussion the categories and subcategories will be outlined and analysed as associated with the institutions regulating insider trading.

3.5.1 The powers and duties of the FSB

The FSB is a self-governing organisation operating independently from the government of South Africa and only from time to time advises the Minister of Finance on financial matters of financial institutions.[161] The FSB has gained executive membership of the International Organisation of Securities Commissions (IOSCO). This will assist the FSB and the JSE in gaining international recognition as institutions upholding international regulatory standards. From the FSB flows the Directorate of Market Abuse (DMA) and the Enforcement Committee that deal with the enforcement of provisions as outlined in the FMA.[162] The Capital Markets department of the FSB is specifically tasked with supervising the JSE. The FSB is a creature of statute and functioning beyond the scope of the powers bestowed upon it in terms of legislation would be *ultra vires*.[163]

158 Whiting 2005 *Responsa Meridiana* 115.
159 Cassim 2007 *SA Merc LJ* 44.
160 Cassim 2007 *SA Merc LJ* 44.
161 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.
162 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.
163 In instances where the FSB should act *ultra vires* it can be regarded as acting beyond the scope of its powers.

Section 84 of the FMA regulates the powers and duties of the FSB in conjunction with the *Financial Services Boards Act* 97 of 1990.[164] The comprehensive supervisory powers of the FSB are provided for in section 84(1) of the FMA.

Section 84(2) of the FMA adds to the comprehensive powers provided for in terms of section 84(1) of the FMA in that it can, subject to section 85, investigate possible market abuse offences;[165] assist the supervisory authority in the investigation of possible market abuse offences;[166] institute proceedings as contemplated in Chapter X of the FMA;[167] administer claims and payments in terms of section 82 on civil liability;[168] publish the results of an investigation via Internet websites or other appropriate public media;[169] establish new market abuse rules after consultation with the directorate,[170] and consult with regulated markets in South Africa (in this instance the JSE) to implement newly established rules to promote effective monitoring and detection of possible market abuses (insider trading in this instance).[171]

The FSB has no power in respect of the prosecution and civil adjudication over complaints received of possible market abuse.[172] A *prima facie* contravention of a provision on insider trading may be investigated by the FSB in order to take regulatory action against the offending institution.[173] Civil disputes have to be dealt with in high court proceedings where the FSB would typically act as an applicant in the matter.[174] The respondent would usually be an institution under the regulation of the FSB. If an investigation into a possible act of insider trading leads to the exposure of a possible criminal offence committed, the FSB has to refer the matter for criminal prosecution. The National Prosecuting Authority (NPA) is a statutory body with the authority to institute and perform criminal prosecutions.[175] The FSB can offer its investigative

164 S 84 of the *Financial Markets Act* 19 of 2012. This section reflects the same provisions as in s 82 of the *Securities Services Act* 36 of 2004.
165 S 84(2)(a) of the *Financial Markets Act* 19 of 2012.
166 S 84(2)(b) of the *Financial Markets Act* 19 of 2012.
167 S 84(2)(c) of the *Financial Markets Act* 19 of 2012.
168 S 84(2)(d) of the *Financial Markets Act* 19 of 2012.
169 S 84(2)(e) of the *Financial Markets Act* 19 of 2012.
170 S 84(2)(f) of the *Financial Markets Act* 19 of 2012.
171 S 84(2)(g) of the *Financial Markets Act* 19 of 2012.
172 Chitimira *The Regulation of Insider Trading* 97.
173 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.
174 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.
175 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.

assistance to the NPA, but the NPA has to fulfil its functions without any intervention from any individual or institution.

The FSB has a small in-house legal department that deals with legal matters. The FSB is regarded as a young institution as it was established 22 years ago and is considered to have limited resources. There have been no successful cases of criminal prosecution of insider trading in South Africa, which might be due to the lack of resources associated with the investigation stage into a possible offence of insider trading. It is suggested that the FSB should be allocated a larger part of the national budget and attain more representatives in order to function more effectively in its interrogations, search and seizure of premises and easy application to courts in cases where possible offences of insider trading have been committed.

3.5.2 The functioning and role of the DMA

Section 85 of the FMA provides for the functioning and role of the DMA. The DMA is a committee as established by the FSB, the members of which are appointed by the Minister of Finance.[176] The membership is constituted of members of the accounting, legal, insurance, fund management and banking professions as well as the South African Reserve Bank.[177] In terms of section 85(1) of the FMA, the DMA is empowered to institute civil proceedings and to investigate possible acts of insider trading. It can furthermore warrant a search and seizure of the premises under regulation of the FSB, and may summon any individual to appear at an inquiry as part of the investigation into a possible act of insider trading.[178] The DMA can refer a matter to the Enforcement Committee, the NPA, or can institute civil proceedings. The DMA only acts on behalf of the FSB.

3.5.3 The Enforcement Committee

The Enforcement Committee was established in 2008 and its functioning is governed by section 10A of the *Financial Services Boards Act* 97 of 1990. It has been tasked with providing an alternative remedy in resolving disputes based on possible market abuse

176 Chitimira *The Regulation of Insider Trading* 98.
177 S 85(3) of the *Financial Services Act* 19 of 2012.
178 S 85(3) of the *Financial Services Act* 19 of 2012.

(in this instance insider trading). In this process the registrar has the opportunity of arguing its case before an impartial and objective panel as opposed to deciding the outcome of an investigation by him.[179] The members of the committee are made up of attorneys and advocates with at least ten years experience and are currently chaired by a retired judge.[180] Once a new matter has been referred to the committee by the registrar, the chairperson or deputy chairperson assigns the matter to a panel of not less than three members to adjudicate the matter.[181]

The Enforcement Committee can enforce administrative penalties on offenders of insider trading and any determination made can be appealed or reviewed in a high court.[182] An order made by the Enforcement Committee can be accompanied by a settlement agreement. In the case of *The Directorate of Market Abuse v Comair Limited*, Comair Limited (the respondent) contravened section 78 of the FMA.[183] The committee imposed a penalty of R70 000 for the contravention of section 78 of the FMA and a further R30 000 for investigation costs incurred by the DMA. This order was accompanied by a settlement agreement setting out the terms and conditions the respondent had to fulfil in paying the penalty of R70 000.

3.5.4 Taking stock of the enforcement mechanisms

In determining the success of the newly implemented FMA it has to be measured against the adequate enforcement of its provisions. In terms of section 84, the FSB has enforcement and monitoring duties which will, if failed to comply with, make prosecution for the offence of insider trading and holding persons civilly liable impossible. The current legal dispensation does not promote a right of action for affected persons. This does not align with the idea of justice for all and the FSB is not considered to be easily accessible to persons who were wronged and seeking justice.

The DMA furthermore has not produced the required results with the majority of its investigations still pending.[184] This might be due to the DMA's limited powers. The

179 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.
180 S 10A of the *Financial Services Boards Act* 97 of 1990.
181 S 10A of the *Financial Services Boards Act* 97 of 1990.
182 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.
183 *The Directorate of Market Abuse v Comair Limited* 09/2014.
184 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.

Enforcement Committee also has limited powers in that it may only adjudicate referred matters relating to contraventions of sections 78 and 81 of the FMA and instances in which the defendant refused to pay its penalties. The success of criminal prosecutions lies with the flowing through of reference on the part of the NPA. Until lately there have been no successful criminal prosecutions of insider trading.

It is submitted that the current regulatory framework is not adequate in dealing with the market abuse of insider trading. Due to limited resources and a substantial back-log in courts, regulatory entities and the NPA are discouraged from successfully completing investigations and prosecuting offenders in respect of possible acts of insider trading. There is a need for more practical measures to combat the market abuse of insider trading.

3.6 Conclusion

The FMA's objective is to eliminate the inadequacies of the SSA. The problems associated with the SSA are still a concern as the criminal penalties still do not have the deterrent powers as intended. More appropriate sanctions are called for, such as a ban for life from directorship or cancellation for life of trading licences. By founding the Enforcement Committee in dealing with insider trading, it still has not delivered the desired result in combating insider trading.

Legislative reform is called for in respect of the definitions of "deal" and "dealing". The FMA's current definition of "deal" is too broad and vague and the definition of "dealing" has not been provided for in the Act. The definition of "deal" has to be redefined and the definition of "dealing" has to be incorporated into the Act to limit contraventions of section 78 of the FMA.

The extra-territorial application of the FMA creates the impression that practical steps are being taken to combat insider trading. This open-ended nature of the regulatory framework is unnecessary and too broad. The financial burden that the extra-territorial application of the FMA encompasses is too large, and with the limited resources available to the FMA its scope and application has to be limited to South Africa. This will assist in successfully combating the crime of insider trading. Another major flaw

associated with the new FMA is that it limits the scope of the provision on insider trading to dealing in securities in regulated markets (the JSE). This indicates that other money market instruments are excluded from the auspices of the insider trading provisions as outlined in the FMA, and that the offence of insider trading thus holds a new threat for unregulated markets.

There is furthermore no rigorous and mandatory disclosure mechanism of inside information. Price sensitive information has to be published via the JSE's SENS network and is a requirement in terms of the JSE Listing Requirements. Legislative reform is called for in this regard to include this requirement into statute. In this regard the example of jurisdictions such as the United States of America, United Kingdom and Hong Kong can be followed.

Section 78(5) of the FMA can be amended to include the encouragement or discouragement offence in respect of a third party. It is unclear why the legislature decided to exclude such a third party from being guilty of the offence of insider trading.

The right to claim is furthermore limited to the FSB. This rigid approach does not promote justice for all and is a deterring factor to third parties seeking to claim in instances in which insider trading have occurred. Section 82 of the FSB has to be amended to include provisions on the calculation of interest in respect of an administrative penalty imposed. Clear stipulations as to the identification of the capital amount and the interest rate have to be outlined in this regard.

The wording of section 82(3) of the FMA has to be amended. This will clarify as to whether the FSB might have an odd double claim against an insider trader or/and a third party. The defence to section 78(1)(b)(i) of the FMA has to be clarified as uncertainty prevails as to whether the element of *mens rea* is compulsory in incurring liability on the part of an alleged insider trader. The legislature can include a Chinese Wall defence. This will limit the flow of price sensitive information within a company or institution.

Due to the limited resources of the FSB, it is suggested that a larger portion of the national budget be allocated to the combating of financial crimes. This will ensure that

the FSB will be able to attain a larger workforce to assist in successfully concluding interrogations of witnesses, search and seizure of properties, and applications to the relevant high courts.

There are still many inconsistencies associated with the FMA. It is submitted that the current regulatory framework on insider trading is still inadequate in dealing with the challenges associated with insider trading.

Chapter 4 Insider trading within the ambit of Hong Kong's law

4.1 Introduction

Insider trading is a common form of securities fraud in Hong Kong and is considered to be one of the most controversial elements of securities regulation.[185] The rationale associated with the regulatory legislation on insider trading in Hong Kong is based on the idea of fairness, investor protection and market confidence.[186] The Stock Exchange of Hong Kong Limited (SEHK) is ranked number seven in terms of the world's largest financial centres.[187] It is considered to be the most efficiently regulated market in Asia and its corporations are least likely to trade on inside information in comparison with other Asian countries.[188] In 2003 the legislatures introduced the Securities and Futures Ordinance (SFO) as outlined in Chapter 571, which provided for the commencement of the dual civil and criminal insider trading regime.[189] By successfully enforcing the SFO, insider trading activities will be prevented. This will contribute to the promotion of investor confidence in the SEHK and the financial reputation of Hong Kong. It is against the backdrop of the SFO that the Hong Kong regulatory framework in respect of insider trading will be analysed.

This chapter aims to discuss the historical development of the insider trading laws of Hong Kong. Thereafter a critical discussion will follow on the current regulatory framework on insider trading in Hong Kong. The section will incorporate the relevant case law on insider trading that resulted in successful convictions since the enactment of the SFO in 2003. The discussion will conclude with remarks on possible developments in Honk Kong's insider trading laws and whether principles of Hong Kong's law should be incorporated in South African legislation.

185 Chan 2013 *Australian Journal of Corporate Law* 271.
186 Bhattacharya and Daouk 2002 *Journal of Finance* 75.
187 Thompson 2013 *International Journal of Accounting and Financial Reporting* 3.
188 Hung and Trezevant 2003 *Working Paper of University of South Carolina* 40.
189 Chan 2013 *Australian Journal of Corporate Law* 272.

4.2 A historical overview of the insider trading legislation of Hong Kong

In 1974 an initial attempt was made to enforce insider trading legislation and specifically enforcement of provisions combating the form of market abuse as a criminal offence.[190] In 1978 the first enforcement committee was created and the Insider Dealing Tribunal (IDT) was introduced under the scope of portion XIIA of the Securities Ordinance.[191]

A need was identified to review the insider trading legislation and the Securities Review Committee (SRC) was established in 1988. The purpose of the SRC was to review the administration, infrastructure and regulation of the SEHK. The SRC's findings were published in the Hay Division Report.[192] The main findings of the report indicated that an immediate regulatory authority had to be established, as the securities and futures markets were operated on a private benefit basis as opposed to a public entity for the benefit of investors and listed companies on the SEHK.[193] In response to these findings the Securities and Futures Commission (SFC) was established in 1989.[194]

In 1991 the regulatory legislation on insider trading underwent its first reform. The Securities (Insider Dealing) Ordinance (Chapter 395) was enacted, a more complete definition of insider dealing was created, and the IDT was authorised to impose penalties on insider traders. At that stage insider trading was still not criminalised. Offenders who were found guilty of insider trading could only lose their directorships or management powers for up to five years.[195]

A new Securities and Futures Bill was drafted in 1996 with the aim of consolidating 8 of the then 11 existing ordinances on securities regulation. The provisions as in the Securities (Insider Dealing) Ordinance of 1991 were taken as they had been, with the minor change of authorising the IDT to impose an administrative penalty on insiders for investigation costs incurred by the SFC.[196]

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190 Chan 2013 *Australian Journal of Corporate Law* 273. The legislature proposed to implement s 140 of the Securities Ordinance to impose a criminal liability on insiders.
191 Wacks 1999 *Hong Kong University Press* 260.
192 Securities Review Committee 1988 http://www.sfc.hk.
193 Securities Review Committee 1988 http://www.sfc.hk.
194 Chan 2013 *Australian Journal of Corporate Law* 274.
195 Chan 2013 *Australian Journal of Corporate Law* 274.
196 Wacks 1999 *Hong Kong University Press* 266.

A clear and definite need for regulatory reform was identified in respect of Hong Kong's insider trading legislation in 1999. The Securities and Futures Bill of 1996 was revised to align with international regulatory standards on insider trading.[197] The benchmark legislative reform occurred in 2003 in respect of Hong Kong's insider trading laws. A dual civil and criminal insider trading regime was established and the new SFO was enacted. The IDT was replaced by the Market Misconduct Tribunal (MMT) to deal with all civil aspects of insider trading cases, while the courts have since then been responsible for prosecuting criminal offenders of insider trading.[198] The following part of the discussion will explain the current regulatory framework of Hong Kong's insider trading laws in more detail.

4.3 The current regulatory framework on insider trading in Hong Kong

4.3.1 Insider trading in terms of sections 270 and 291 of the SFO

The offence of insider trading is regarded as a serious form of market abuse in Hong Kong. The court stated in the case of *HKSAR v Ma Hong-yeung and Others* that insider trading should be regarded as serious dishonest conduct. It was furthermore held that insider trading is a threat to the financial regulated markets in Hong Kong. If it is to maintain its constant position in the market place, it will negatively influence the transparency of the markets and cause a decline in Hong Kong's financial position as an international financial centre.[199]

The offence of insider trading is defined in the SFO and the most important provisions thereof are contained in portions XIII and XIV of the SFO.[200] Eight types of insider trading can be identified. Section 270 (1) of the SFO sets out the civil offences of insider trading while section 291(1)-(6) of the SFO sets out the criminal offences.[201] The establishment of a dual criminal and civil regime in governing insider trading in Hong Kong resembles the relevant regime on insider trading in terms of the FMA in South

197 Wacks 1999 *Hong Kong University Press* 267.
198 MMT 2013 http://www.mmt.gov.hk. The tasks of the MMT include that of investigating different forms of market abuse, conducting civil proceedings and imposing civil sanctions on those held liable for different forms of market abuse.
199 *HKSAR v Ma Hong-yeung and Others* DCCC 229-224/2008 at par 29.
200 Securities and Futures Ordinance in Chapter 571.
201 S 270(1) and s 292(1) to(6) of the Securities and Futures Ordinance of 2003.

Africa. Section 78 and 82 of the FMA respectively provides for the regulation of insider trading as a criminal offence as well as the civil liability associated therewith.

A connected person/insider commits insider trading when he/she deals on relevant information, related to a corporation, on a regulated market. The insider can also be guilty of the offence if he/she counsels another to deal in the securities related to the relevant information.[202] This is the most popular form of insider trading and is linked to the Chinese culture of collectivism. In most of the recorded insider trading cases the offenders were linked as employees to the company in which securities it traded. An offeror in a takeover situation can also be guilty of insider trading if he/she deals in securities in respect of the listed corporation to which the takeover pertains and the inside information obtained during the takeover proceedings are utilised to base the insider's trades on. The insider can furthermore be guilty in the same sense, should he/she counsel or procure another to deal in the securities for another purpose than the takeover.[203] These first two offences of insider trading can be categorised into one group to include insiders who deal, counsel or procure others to deal. These sections are similar to section 78 of the FMA's encouragement or discouragement offence.

The second group of insider traders can be held liable as tippers. Liability occurs based on the direct or indirect disclosure of inside information by an insider to another person. The element of reasonability should be present in believing that the other person will trade based on the disclosed inside information.[204] This same offence can occur in terms of takeover situations.[205]

The third and final group of insider traders are tippees.[206] The SFO provides for instances when an insider can be held liable based on the information he/she received, directly or indirectly, from an insider trader or a takeover offeror and dealing in the securities of the listed company to which the inside information relates, or counselling another to deal based on the information received.[207] This is the second most popular

202 S 270(1)(a) and S 291(1) of the Securities and Futures Ordinance of 2003.
203 S 270(1)(b) and S 291(2) of the Securities and Futures Ordinance of 2003.
204 S 270(1)(c) and S 291(3) of the Securities and Futures Ordinance of 2003.
205 S 270(1)(d) and S 291(4) of the Securities and Futures Ordinance of 2003.
206 Chan 2013 *Australian Journal of Corporate Law* 276.
207 S 270(1)(e) and (f) and S 291(5) and (6) of the Securities and Futures Ordinance of 2003.

form of insider trading and, as indicated in the *Ma Hon-yeung* case, it can be due to the Chinese culture of sustaining interpersonal relationships.[208]

Sections 270(2) and 291(7) of the SFO furthermore impose a civil liability[209] on insiders and criminalise[210] insider trading in respect of securities that are dually listed on the SEHK as well as outside the parameters thereof.[211] In South Africa the FMA has a similar extra-territorial application. The problems associated with the South African extra-territorial application are discussed in the conclusion of Chapter 3. Hong Kong deals with this problem as practically indicated in the *Tiger Asia* case as discussed in section 4.3.3.2 of this chapter.

4.3.2 Key concepts in insider trading

In order to create a better understanding of insider trading as outlined in sections 270 and 291 of the SFO, key concepts are forthwith clarified. "Relevant information" is defined in terms of section 245(1) of the SFO and constitutes information that is not generally known, and which is material and specific.[212] In the MMT report on the insider trading case of *Firestone International Holdings Ltd* it was held that the specificity of inside information relates to the clearly identifiable, definite and expressed nature thereof.[213] It was furthermore held by the tribunal that not every single detail of an insider transaction has to be defined, but a clear and substantial commercial reality should exist when parties intend to negotiate a trade with profit as a goal.[214]

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208 In the *Ma Hon-yeung* case the insider trader tipped four of his friends and relatives in dealing in securities relative to price sensitive information. This was the first case in which a jail sentence was ordered on the tipper (Ma Hon-yeung) of 26 months imprisonment.

209 S 270(2)(a) of the Securities and Futures Ordinance of 2003.

210 S 291(7) of the Securities and Futures Ordinance of 2003.

211 Chan 2013 *Australian Journal of Corporate Law* 276.

212 S 245(1) of the Securities and Futures Ordinance of 2003. "Relevant information" specific information about a corporation, a shareholder or officer of the corporation, or the listed securities of the corporation or their derivatives, which is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation, but which would, if it were generally known to them, be likely to materially affect the price of the listed securities.

213 MMT report of *Firestone International Holdings Ltd* 2 April 2004 p 60.

214 MMT report of *Firestone International Holdings Ltd* 2 April 2004 p 62.

The material nature of "relevant information" was discussed in the IDT report of *Lafe Holdings Ltd*.[215] The tribunal indicated that inside information regarded as "relevant information" has to cause a significant change in the price of the traded securities to which the information relates, and not just a slight change therein.[216] Materiality can be measured against the likelihood that regular investors who trade on the securities would be motivated to buy or sell.[217] It is hereby submitted that "relevant information", as referred to in sections 270 and 291 of the SFO, is inside information that is not known to the general investing public, that affects the price of traded securities in a significant manner, and is specified in a such a manner to motivate the goal of accumulating profit.

An insider is a person who "deals", whether as principal or agent; buys, sells, exchanges, subscribes, acquires, disposes of or agrees to the above in respect of listed securities.[218] Insider trading can also occur when a person (considered as the insider) with relevant information procures or counsels another person to deal.[219] The following part of the discussion will focus on the penalties associated with the offence of insider trading in Hong Kong.

4.3.3 Penalties for insider trading in Hong Kong

Three types of penalties are provided for in the SFO.[220] These three types are: criminal sanctions, administrative penalties (civil penalty), and civil penalties associated with an individual investor's right to claim. The SFO authorises the SFC to investigate and inquire into suspected insider trading activities.[221] Possible insider trading cases are then referred to either the Financial Secretary to initiate civil actions before the MMT, or to the Secretary of Justice to initiate criminal proceedings in a high court of first instance.[222]

The penalties of insider trading in Hong Kong are discussed in the following subcategories.

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215 IDT report of *Lafe Holdings Ltd* 20 February 1990 p 58.
216 IDT report of *Lafe Holdings Ltd* 20 February 1990 p 58.
217 IDT report of *Hong Kong Parkview Group Limited* 5 March 1997.
218 S 247(1) of the Securities and Futures Ordinance of 2003.
219 Chan 2013 *Australian Journal of Corporate Law* 276.
220 Macksey 2005 http://www.deacons.com.hk.
221 Asaro 2013 *The Hedge Fund Law Report* 13.
222 Asaro 2013 *The Hedge Fund Law Report* 13.

4.3.3.1 Criminal sanctions

Section 303(1) of the SFO imposes a maximum fine of HK$10 million and up to 10 years imprisonment on persons guilty of the offence of insider trading. Aside from cases being referred to the Secretary of Justice to follow through on criminal prosecutions, the Financial Secretary may refer a case to the Secretary of Justice once the Financial Secretary is of the opinion that an offence in terms of the criminal provisions of the SFO has occurred.[223]

In deciding whether an insider trading case should be criminally prosecuted the SFC has to follow the prosecution guidelines as set out by the Department of Justice.[224] The weight of the evidence in respect of instituting and continuing criminal proceedings and the public interest in bringing the criminal prosecution before a court are determining factors in deciding whether to institute criminal proceedings.[225] Due to the heavy burden of proof in criminal proceedings, the SFC will only proceed with this avenue if the evidence is admissible, substantial and reliable in proving a criminal offence of insider trading. These factors are quite ambiguous as the SFC has the sole discretion in deciding whether evidence is admissible and substantial and it is completely subjective and nearly impossible to determine the public interest in a case. Since 2007 the SFC has amended its approach in determining which cases are to be criminally prosecuted.[226] The SFC now refers all insider trading cases to the Director of Public Prosecution from where cases can be criminally prosecuted.[227] Since 2008 eight criminal convictions of insider trading were recorded and six civil orders were imposed.[228] This removes the criticism that the SFC lacks the ability to use its authority to prosecute insider trading. This can be followed as a guideline for the FSB in South Africa where all insider trading cases can be referred to the NPA after which offenders can be criminally prosecuted and if no criminal prosecution is possible, the case should be referred back to FSB in order to follow through with a civil claim against the inside trader.

223 Asaro 2013 *The Hedge Fund Law Report* 14.
224 Department of Justice 2013 http://www.doj.gov.hk 36.
225 Department of Justice 2013 http://www.doj.gov.hk 36.
226 North 2009 *C & SLJ* 27.
227 The first case of *HKSAR v Ma Hon-yeung* DCCC 229-240/2008 followed the revised approach of referring insider trading cases to the Director of Public Prosecution.
228 Chan 2013 *Australian Journal of Corporate Law* 276.

In most criminal cases of insider trading, Hong Kong courts utilise the determining factors as outlined in the English case of *R v Christopher McQuid* as a guideline in sentencing criminal offenders of insider trading.[229] The factors to be taken into account are: a) the nature of the insider's employment enabling him/her to commit insider trading; b) the circumstances in which he/she was able to obtain inside information; c) the reckless or dishonest nature of the insider's behaviour; d) the level of complexity and deception involved in the insider's activity; e) whether the insider acted alone; f) the expected financial benefit; g) the impact (if proven) on an individual victim, and h) the effect of the inside trade on the general public confidence in the integrity of the market. Some of these factors require an objective determination while the rest require the subjective discretion of the courts in determining the outcome thereof. These guidelines have been successfully applied in criminal cases in Hong Kong. In South Africa no such guidelines exist as determining factors in criminal cases. South African courts can look to international case law such as the abovementioned *Christopher McQuid* case to assist in criminal prosecutions of insider trading.

The major difficulties associated with insider trading cases are identifying insider trading and then proving knowledge or reasonable knowledge on the part of the offender. A question arises as to the available resources of the SEHK and the SFC to enforce the provisions of the SFO. The SEHK regulates its market by utilising the Listing Rules but has no statutory authority to institute legal proceedings against insider traders. It immediately discloses any information as to a possible contravention of the provisions of the SFO to the SFC by virtue of a Memorandum of Understanding between the SFC and the SEHK. This separates the powers and duties of the two regulators.[230] Specifically identifying definite roles of the SEHK and the SFC in combating market abuses such as insider trading, will assist in easier and faster investigations and conclusions to insider trading cases. This position on a separation of powers in Hong Kong resembles the ideology of a so called "Twin Peaks – model" as researched in South Africa.[231] The "Twin Peaks – model" proposes a separation of roles and duties of regulatory authorities. In terms of this model the South African Reserve Bank will be authorised to implement its authority over all the banks and similar banking institutions in South Africa in acting as a prudential regulator while the FSB will be responsible for

229 *R v Christopher McQuid* 2009 All ER (D) 100.
230 Chan 2013 *Australian Journal of Corporate Law* 283.
231 Reinecke, Van Niekerk and Nienaber 2012 http://www.fsb.co.za.

regulating the trades on securities and derivatives and will be able to instigate investigations where a possibility of insider trading exists. This will outline the FSB's role as market conduct regulator. It is suggested that the FSB, JSE and South African Reserve Bank enter into a Memorandum of Understanding that will define their separate roles, powers, duties and authority as regulatory institutions.

It is submitted that the number of insider trading cases on the SEHK is directly correlated with the external economic environment. In 2008 the highest number of insider trading cases occurred. In the same period the housing bubble in the United States burst, causing a downward adjustment to the SEHK and a drastic fluctuation and volatility in Hong Kong's economy.[232]

It is furthermore submitted that imprisonment as a criminal sanction has the strongest deterrent effect on possible offenders of insider trading in Hong Kong. The social stigma that it carries and the fact that the financial penalties are equal to the profits gained (or loss avoided) outweigh the financial benefit to some insiders.

4.3.3.2 The administrative penalties

In terms of section 213 of the SFO, administrative powers are delegated to the SFC. This section determines that the SFC can apply to the courts in order to obtain an administrative order. These court orders include: a) the appointment of an administrator of a company in instances where any notice, requirement or relevant provision of the SFO have been contravened; b) an interim injunction to restrict insiders or connected persons to a company to dispose of property of a company if the act of insider trading is suspected, and c) an injunction against an alleged insider to dispose of property if sections of the SFO have been contravened.[233]

In *SFC v Tiger Asia Management LLC* the SFC utilised section 213 of the SFO in an attempt to seek compensation from Tiger Asia Management LLC (hereafter referred to as Tiger Asia) without finding them guilty of insider trading.[234] On 6 January 2009 three

232 Reavis 2009 http://www.mitsloan.mit.edu.com.
233 In terms of s 213 the person would face financial liability to either pay an administrative penalty or disgorge profits earned.
234 *SFC v Tiger Asia Management LLC* 30 April of 2013.

senior officers of Tiger Asia received confidential and price-sensitive information regarding China Construction Bank Corporation Ltd shares from a placing agent in Hong Kong. In this case Tiger Asia was a New York-situated hedge fund.

On the same day of receiving the price-sensitive information, Tiger Asia sold 93 million of its China Construction Bank Corporation Ltd shares prior to any public announcement disclosing the price-sensitive information. On 7 January 2009 Tiger Asia bought back their shares at a discounted price compared to the prevailing market price and ultimately made a profit of HK$38.5 million. Due to the fact that no Tiger Asia branch was located in Hong Kong, no criminal prosecution could be executed by the SFC. The matter could also not be referred to the MMT in order to charge Tiger Asia in a civil matter, as no witnesses or suspects could be located to attend to hearings or inquiries. In turning to section 213 of the SFO the Court of Final Appeal upheld the SFC's right to seek administrative justice and found in favour of the protection of investor's interest.

The MMT is empowered in terms of sections 257(1) and 303(2) to impose administrative penalties on companies guilty of insider trading. In terms of these sections, an insider can be prohibited from fulfilling a managerial roll in a company for up to five years.[235] Further sanctions that the MMT can impose include: a) a "cold shoulder" order;[236] b) a "cease and desist order";[237] c) a disgorgement order;[238] d) a government cost order;[239] e) a SFC cost order,[240] and a disciplinary referral.[241]

235 S 257(1)(a) and s 303(2)(a) of the Securities and Futures Ordinance of 2003.

236 In terms of s 257(1)(b) and s 303(2)(b) of the SFO, the MMT can impose this type of order on a person in order to deprive the offender of market access and the facilities thereof for up to five years.

237 S 257(1)(c) of the SFO pertains to the disclosure offence and orders an insider not to breach the statutory disclosure requirements as outlined in the SFO.

238 The insider is ordered in terms of s 257(1)(d) of the SFO to pay an amount, equivalent to the loss avoided or profit gained to the government of Hong Kong.

239 The costs of the inquiry and investigation costs incurred by the SFC are repaid by the insider in terms of s 257(1)(e) of the SFO.

240 S 257(1)(f) of the SFO provides for an order regarding the SFC's investigation costs into the insider's affairs pre and post a trial or inquiry.

241 S 257(1)(g) and s 303(2)(c) of the SFO authorises the MMT to provide other relevant regulatory bodies with a report on the proceedings against the insider in order for them to take further disciplinary action against the insider if need be.

4.3.3.3 Civil liability – penalties associated with a private right of action

A private right of action is provided for in terms of sections 281 and 305 of the SFO which pertain to both civil and criminal proceedings. An order granted by a court or imposition of a penalty by the MMT does not disqualify a private individual investor's right to claim for compensation from an offender.[242] The concept of what is to be regarded as fair, just and reasonable regarding a civil claim by an individual investor is in contention. It is held that delictual principals are to be applied by the courts in this regard in that a causal link has to exist between the insider trading and the individual investor's activities or loss. These elements have to be present for a private action to exist against an offence of insider trading.[243] There is currently no such private right of action by a private individual against in insider trader. Legislative reform is called for in South Africa in this regard.

4.4 Conclusion

This discussion indicates that in recent years the regulatory framework on insider trading in Hong Kong has enjoyed increased attention and growth. The Hong Kong regulators are now considered to be of the most rigorous and tough. The increased number of criminal convictions confirms the unambiguous approach followed by enforcers of Hong Kong's insider trading legislation. This indicates that harsh financial penalties and imprisonment accompany an act of insider trading. The newly reformed SFO is however not without flaws, as insider trading still occurs. A recurring problem the SFC experiences is the difficulty in investigations into companies beyond the extra-territorial reach of Hong Kong's regulated markets but this problem can be overcome, as indicated in the *Tiger Asia* case. A worthwhile approach for the SFC to explore is the temporary or permanent deregistration of audit firms from uncooperative countries in supplying the SFC with documents and information that will enable it to successfully investigate into possible cross-border insider trading offences. The effective regulation of insider trading is furthermore hindered by any instability in the economic environment as well as the Chinese culture of interpersonal relationships. The newly instated dual civil and criminal regime in respect of insider trading may assist in It is finally submitted that the element of greed may in certain instances still outweigh the financial penalties

242 Chan 2013 *Australian Journal of Corporate Law* 280.
243 Cheung 2013 *Company Law* 56.

and criminal sanctions associated with insider trading and that eradicating insider trading may be an impossibility.

It is finally submitted that the South African regulatory authorities should incorporate the practical measures as applied in Hong Kong in order to assist it with the first criminal prosecution for insider trading. These practical measures include: a) Direct referral of insider trading cases to the NPA, b) Incorporating international case law guidelines to criminally prosecute insider traders, c) Concluding Memorandums of Understanding between the FSB, JSE and the South African Reserve Bank in order to successfully implement the "Twin Peaks – model" in regulation of banks, market abuse and trades of securities and derivatives and d) Reforming the FMA to include a private right of action by an individual against an insider trader.

Chapter 5 Conclusion and recommendations

5.1 Introduction

In order to eradicate insider trading with the purpose of improving the reputation of the South African financial market and to ensure investment flows, the newly instated FMA has to be amended. The purpose of the repeal of the SSA was to promulgate a new act in order to eradicate the market abuse of insider trading that negatively influences the effective working and reputation of the South African economy and the JSE.

From the discussions in the previous chapters it is submitted that the FMA has not successfully eliminated the legislative flaws associated with the SSA. It has only carried these flaws forward to Chapter X of the FMA which outlines the provisions on market abuse and specifically the sections on insider trading. The purpose of this chapter is to recommend plausible solutions associated with the insider trading problem on South Africa's regulated market, the JSE. These recommendations will endeavour to align South Africa's regulatory framework on insider trading with international best practice principles.

5.2 Recommendations

5.2.1 Implementation of the "Twin Peaks model"

The *Financial Sector Regulation Bill* and its revised version were subsequently tabled in Parliament during July 2014. In terms of this Bill the SARB is outlined to perform the functions of a prudential regulator and the FSB is to act as market conduct regulator. The purpose of the "Twin Peaks model" is focused on enhanced consumer protection and promoting stability within South Africa's financial system. In terms of this model the SARB will be responsible for the promotion of the financial soundness and health of the banking institutions and the FSB for enhancing the confidence in South Africa's financial markets. The principles the SARB and the FSB stand to promote through the "Twin Peaks model" mainly align with the objectives as set out in the FMA. These principles include the elements of transparency, acting as credible deterrent to market misconduct,

aligning with international best practise principles, consistent, focused on the final outcome, risk-based and pro-active.

The promulgation of the *Financial Sector Regulation Bill* will assist in combating insider trading. The FSB will be focused on implementing the principles as outlined by the Bill. This will promote a more stringent approach to the regulation of market misconducts, such as insider trading, in South Africa. It is recommended that the "Twin Peaks model" be implemented in South Africa. This position aligns with that of Hong Kong as discussed in section 4.3.3.1.

5.2.2 Deterrence alone should not be the only goal

Financial penalties associated with civil liability and harsh criminal sanctions contribute to the deterrence of insider trading. This, however, should not be the only goal of the regulatory framework, and policies regarding early detection and prevention of acts of insider trading should form part of the policy goals. Section 105 of the FMA only provides for a fine of up to R50 million and/or 10 years imprisonment. Until late the highest fine for insider trading by a person has been R2,5 million as ordered in *The Directorate of Market Abuse v Assore Limited* and there has been no successful criminal prosecutions for insider trading. By imposing other appropriate sanctions such as a ban for life from directorship or a cancellation for life of trading licences will deter and prevent future acts of insider trading. This resembles Hong Kong's provisions on penalties as provided for in sections 257 and 303 of the SFO and as discussed in section 4.3.3.2 of Chapter 4.

5.2.3 Promoting awareness and education on insider trading

Currently only the JSE booklet on insider trading, as requested by the Minister of Finance, provides guidance and attempts to promote awareness on insider trading to relevant public investors. Public campaigns on investors' rights and the possible consequences of an act of insider trading are called for in order to educate relevant investors on insider trading and the regulatory framework accompanying it in South Africa. The element of knowledge on the part of an insider and as outlined in section 78 of the FMA has proven to be the hardest element to prove on a balance of probabilities.

This hinders successful prosecutions of insider trading. The education of investors in this regard will assist in eliminating the difficulties associated with proving the element of knowledge.

5.2.4 Implementing statutory measures on disclosing price sensitive information

A mandatory disclosure mechanism of price-sensitive information has to be incorporated into the FMA. The current position is that price sensitive information is published via the JSE's SENS network and is a requisite in terms of the JSE Listing Requirements. As the FSB and the courts are creations of statute, statutory measures on disclosing price sensitive information have to be implemented. The SFO in Hong Kong currently provides for the statutory disclosure of price-sensitive information in terms of section 307 B. This section requires a listed company to disclose relevant price-sensitive information to the public as soon as it becomes available and reasonably possible. Section 307 C furthermore requires that the information be disseminated to the public via an electronic system to ensure equal, timely and effective access by the public to the disclosed information. These sections should be mirrored in the FMA to ensure that a statutory duty of disclosure is implemented in South Africa.

5.2.5 Memorandums of understanding with extra-territorial reach

The FSB of South Africa and the SFC of Hong Kong have gained executive membership of the IOSCO as well as of the international Financial Stability Board. Their membership ensures access to a community of international regulators. The Financial Stability Board promotes adherence to the IOSCO international best practice principles. Members of the Financial Stability Board furthermore commit to undergoing periodic peer reviews in respect of adherence to international regulatory standards.[244] South Africa's membership to the IOSCO and the Financial Stability Board can have the benefit of forging relationships with other international regulators and undersigning memorandums of understanding in respect of the regulation of market abuses such as insider trading. Hereby the FSB will be able to gain easier access to information, documents and witnesses that will assist in investigations of suspected acts of insider trading. The added benefit of continuous periodic peer reviews and revision of the South

244 Financial Stability Board 2014 http://www.fsb.com.

African regulatory framework on insider trading will assist with the compliance with international best practice principles.

5.2.6 Access to a private right of action

The FMA does not provide for a private right of action by a person affected by an offence of insider trading as in Hong Kong's sections 281 and 305 of the SFO. It is recommended that an affected investor be able to institute a delictual claim against an insider trader for damages suffered in respect of the act of insider trading. In this regard the affected investor will have to prove a causal link between the damages suffered and the act of insider trading.

5.3 Conclusion

The FMA has attempted to eradicate the legislative flaws associated with the SSA. This study focused on comparatively analysing the provisions on insider trading between the repealed SSA, the FMA and the SFO of Hong Kong. The FMA has been found wanting. By incorporating the recommendations and suggested amendments to the FMA as referred to above and in chapter 3 of this study, the South African regulatory framework can move to full compliance with international best practice principles on insider trading. This will contribute to the transparency of the JSE, improve investor confidence, ensure justice for all, and promote the efficient working of the South African economy.

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