The definitions of ‘inside information’ and ‘insider’ in the Financial Markets Act 19 of 2012

by
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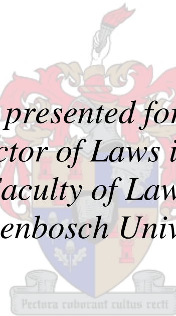

Dissertation presented for the degree of
Doctor of Laws in the
Faculty of Law at
Stellenbosch University

Supervisor: Prof Dr Drs hc Andreas Herculas van Wyk

April 2019

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Voorwoord

Dankie aan Professor Andreas van Wyk. Sonder sy leiding (en met my as student, lyding), vriendskap en aanmoediging sou ek nie `n kans staan om `n doktorsgraad by `n regsfakulteit soos die van die Universiteit Stellenbosch te verwerf nie. Dankie ook vir sy leiding op die ander pad wat ek gedurende die skryf van die proefskrif gestap het: van Marcus Aurelius, Martialis en Cicero, deur tot by Dante, Voltaire en Jan Smuts, maar ook vanaf Stellenbosch tot in Braamfontein; Bloemfontein tot in Sandton.

Dankie aan my ouers, Johann en Senerita van der Walt, wat altyd hulle kinders se belange bo hulle eie stel en wat nooit gehuiwer het om opofferings te maak vir hulle alewige dwars en nuuskierige pensioendief nie.

Dankie aan Regter Dikgang Moseneke, vir die kans van `n leeftyd, vir alles wat hy vir my geleer het, vir toestemming om te registreer vir `n doktorsgraad ten tyde van my klerkskap, en wie vir my gewys hoe `n intellektuele leier van `n hof te werk gaan.

Dankie aan Regter Fritz Brand, wat reg gestaan het met `n ophelp-hand toe ek geval het.

Dankie aan Harold en Erica Verster, dat hulle my so welkom laat voel het in hulle warm Bloemfonteinse huis, met die mooi tuin, die stap-sommer-in kroegie en kombuis, en oorle hond Boris, wat af en toe kom loer het of sy bywoner hom nog gedra.

Dankie aan Martin Kriegler SC, wat selfs `n mens-sku Worcesteriet effens meer gemaklik in Sandton se advokate-kamers laat voel, wat by tye proefskrif aangedrewe nukke moes verduur, en sonder wie se hulp ek lankal by my vriend Jeandré Du Plessis in Auckland sou moes gaan skuiling soek het.

Dankie aan my vriend Jeandré, wat deurgaans sy rusbank beskikbaar gehou het.

En dankie aan Estelle Lilian Bester. Vir so baie goed, insluitende `n pen toe `n skryfdinglose lummel homself langs haar in die maatskappyeregklas neergeplak het, die blommetjiesrokglimlag onder oom Harold se Hadeda-boom, en vir `n rede om uiteindelik die proefskrif klaar te maak.

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Aan Estelle.

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Synopsis

The definitions of 'insider' and 'inside information' in the Financial Markets Act 19 of 2012 are, as is the case with their international counterparts, central to the Act's regulation of insider trading. It has long been recognised, however, that those definitions, inherited from repealed companies and market abuse legislation, are cumbersome and counter-intuitive. This state of affairs obtains as the South African legislature has failed to undertake the most fundamental enquiry in formulating a coherent regulatory scheme aimed at prohibiting supposedly wrongful conduct: identifying a single theory of wrongfulness upon which to base its prohibitions. Instead, the definitions include elements of all possible regulatory bases for insider trading, including those having as their object the protection of proprietary rights in information and born out of the fiduciary doctrine. It is argued that the definitions, part of legislation aimed at addressing a financial market wrong, should be formulated with reference to the rights and obligations at play in those markets and the legislature's objectives for those markets. A proposal is made in that regard.

Sinopsis

Die definisie van 'insider' (binnehandelaar) en 'inside information' (binnekennis) soos vervat in die Financial Markets Act 19 of 2012, staan, soos in ander jurisdiksies, sentraal tot die regulering van binnehandel in dié Wet. Dit word egter lank reeds erken dat daardie definisies, wat hulle ontstaan in herroepte wetgewing aangaande maatskappye en die misbruik van finansiële markte het, omslagtig en onlogies is. Die stand van sake heers aangesien die Suid-Afrikaanse wetgewer nie die mees fundamentele voorafgaande ondersoek onderneem het nie: Die wetgewer het nie een teorie van onregmatigheid geïdentifiseer waarop die verbod op binnehandel baseer kon word nie. In plaas daarvan sluit die definisies elemente van alle moontlike regulatoriese basisse vir binnehandel in, ook die wat mik op die beskerming van eiendomsreg van inligting en wat hulle oorsprong in die fidusiêre beginsel het. Dit word dus aangevoer dat die definisies, as deel van `n stuk wetgewing wat daarop gemik is om die finansiële markte te reguleer, formuleer moet word met verwysing na die regte en pligte relevant tot daardie markte, sowel as die wetgewer se doelwitte met betrekking to daardie markte. `n Dienooreenkomstige voorstel word in die proefskrif gemaak.

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1 INTRODUCTION

In 2006 Jooste, considering the definitions of the terms 'insider' and 'inside information' in South African law, wrote as follows:

> Liability can be incurred only by an 'insider' who acts with knowledge of 'inside information'. The definitions of 'inside information' and 'insider' are accordingly of vital importance. The definitions, which are interconnected, are, however, as in the Insider Trading Act, 'cumbersome and counter-intuitive'. They are in fact circular — to know whether information is 'inside information' one has to know who an 'insider' is; and to know who an insider is, one has to know what 'inside information' is. 'Inside information' is information 'which is obtained or learned as an insider'; and an 'insider' is a person who has 'inside information'. Since the provisions of the Act that impose criminal and civil liability turn on the meaning of 'inside information', the Act is 'fundamentally incoherent'.[1]

Jooste wrote on the definitions as they stood in the Securities Services Act.[2] That Act was repealed. The South African insider trading provisions, including the definitions of 'inside information' and 'insider', are now to be found in the Financial Markets Act[3] (the Financial Markets Act or Act). Jooste's criticism, however, was not heeded by the legislature and still rings true. At the least, his criticism calls for a proper analysis of the definitions. Specifically, what needs to be ascertained is whether the definitions cannot be clarified and, ultimately, whether the law on insider trading in South Africa cannot be simplified. As the law stands, it is not clear and it is not simple.

The overarching structure of the Act's insider trading provisions is not novel, regardless of whether it is viewed comparatively or historically. The Act, like most international insider trading regimes and like its historical counterparts, does three main things: it defines a genus

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[1] R Jooste "A critique of the insider trading provisions of the 2004 Securities Services Act" (2006) 123 *S African LJ* 437 438.
[2] Act 36 of 2004.
[3] Act 19 of 2012.

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of information, which it calls 'inside information'; it defines a group of persons, which it calls 'insiders'; and it specifies prohibited conduct or 'offences'. The gist of the regime is that insiders (or those who deal for them) who deal with inside information in specified ways make themselves guilty of offences, which ultimately render them liable to the sanctions prescribed by the Act. The definitions of insider and inside information are central to this legislative scheme. All of the offences include the use of inside information; four of the five offences can be committed only by an insider, and the fifth by someone acting for him (or her).

An insider is liable to harsh sanction[4] if he makes himself guilty of one of four offences.[5] Firstly, if he knows that he has inside information and he deals for his own account in securities listed on a regulated market, he commits an offence.[6] He will, however, not be guilty of that offence if he can prove that he became an insider only after he gave the instruction to deal, and the instruction was not changed after he had become an insider.[7] He would also escape liability if he were acting in pursuit of a transaction, about which all the parties had the same inside information, the trading was limited to those parties, and the transaction was not aimed at securing a benefit from the movement in the price of the security, or a related security, as a result of inside information.[8]

Secondly, if the insider knows that he has inside information and he deals for another person in securities on a regulated market, he commits an offence.[9] He too can, however, escape liability by proving certain facts. He will not be held liable if he is an authorised user and was acting on specific instructions from a client, and he did not know that that client was an insider

4 According to section 82(2)(b) of the Act he is liable to an amount up to R1 million, to be adjusted by the registrar annually to reflect the Consumer Price Index, as published by Statistics South Africa, plus three times the profit made or loss avoided through the offence.
5 Section 78.
6 Section 78(1)(a).
7 Section 78(1)(b)(i).
8 Section 78(1)(b)(ii).
9 Section 78(2).

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at the time.[10] He will not be held liable if he only became an insider after he had given the instruction to deal to an authorised user, and the instruction was not changed after he became an insider.[11] He can also escape liability by proving that he was acting in pursuit of a transaction to which all the parties had possession of the same inside information, the trading was limited to them, and the transaction was not aimed at securing a benefit from exposure to movement in the price of the security, or a related security, resulting from the inside information.[12]

Thirdly, an insider, who knows that he has inside information, and who discloses it to another, is guilty of an offence.[13] He will, however, be able to escape liability where he can prove that he disclosed the inside information because it was necessary to do so for the purpose of the proper performance of the functions of his employment, office or profession in circumstances unrelated to dealing in any security listed on a regulated market and that he, at the same time, disclosed that the information was inside information.[14] Fourthly, an insider who knows that he has inside information and encourages or causes another person to deal or discourages another from dealing in securities listed on a regulated market, is guilty of an offence.[15]

In addition to these four offences, any person 'who deals for' an insider in securities listed on a regulated market and to which the inside information possessed by the insider relates and who knew the person he is trading for to be an insider, is guilty of an offence.[16] He too can, however, escape liability by proving certain specific facts. He will not be guilty of an offence if the insider became an insider only after he had given the instruction to deal, and did not change the instruction in any manner after the insider had been clothed with that status. And,

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10 Section 78(2)(b)(i).
11 Section 78(2)(b)(ii).
12 Section 78(2)(b)(iii).
13 Section 78(4)(a).
14 Section 78(4)(b).
15 Section 78(5).
16 Section 78(3)(a).

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he would not be guilty of an offence if the insider were acting in pursuit of a transaction about which all the parties had the same inside information, trading was limited to those parties, and the transaction was not aimed at securing a benefit from the movement in the price of the security resulting from the inside information.[17]

The offences and their detailed defences do not present a simple legislative scheme. The definitions of insider and inside information add to the interpreter's burden. This should be rectified. For if it is accepted that something must be regulated (as is the case with insider trading), it must be regulated simply and intelligibly. Having simple and intelligible legislation regulating financial markets is a positive characteristic of any modern society. Our legislature of course has a constitutional duty to pass legislation that is clear and precise, enabling citizens to understand what is expected of them.[18] It is also an important tenet of the rule of law that rules are stated in a clear and accessible manner.[19] Bingham gives three reasons why legal rules, including those found in legislation, must be simple and clear.[20]

The first, and perhaps the most obvious reason, is that a member of society must, without undue difficulty, be able to learn what he may and may not do. If legislation is enforced by threat of prosecution, fines or even imprisonment, members of society must at least be able to know what they must or must not do, not to suffer those consequences.[21] This is especially relevant to legislation aimed at regulating conduct in the financial markets. It is a complex, high-paced environment into which the legislature wades. It must tread carefully. Additional

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[17] Section 78(3)(b).
[18] *Investigating Directorate: Serious Economic Offences v Hyundai Motor Distributors* 2001 (1) SA 545 (CC) par. 24.
[19] *Dawood and another v Minister of Home Affairs and others* 2000 (3) SA 936 (CC) par. 47–48.
[20] T Bingham *The Rule of Law* (2010) 37.
[21] Ibid.

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care must be taken to be clear and succinct in order to enable financial actors easily to tell right from wrong.

The second reason is relevant to the claims the Act affords those affected by insider trading.[22] For people to be able to claim under these provisions, they must know what their rights and obligations in terms of the Act are.[23] Only if this is truly the case, would those provisions be effective.

The third reason is eminently relevant to financial market legislation: the successful conduct of trade, investment, and business, to realise economic growth, is promoted by a body of accessible legal rules that governs commercial dealings.[24] Bingham makes the point succinctly: 'No one would choose to do business, perhaps involving large sums of money, in a country where the parties' rights and obligations are vague and undecided.'[25] That proposition is equally applicable to the South African context.

The South African financial markets play an important role in facilitating economic growth. Financial markets play a pivotal role in most national economies today. Share markets specifically have grown tremendously over the last couple of decades. More companies have been listed on stock exchanges and the values of shares have increased in the aggregate, both as a result of a general increase in share prices and through the listing of new shares. An

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22 Section 82(5).

23 Bingham *The Rule of Law* 38.

24 Ibid.

25 Ibid. Lord Mansfield, recognised by many to be the father of English commercial law, wrote as follows more than 250 years ago: 'The daily negotiations and property of merchants ought not to depend on subtleties and niceties; but upon rules easily learned and easily retained, because they are the dictates of common sense, drawn from the truth of the case" (*Hamilton v Mendes* (1761) 2 Burr 1198 1214) and 'In all mercantile transactions the great object should be certainty: and therefore, it is of more consequence that a rule should be certain, than whether the rule is established one way or the other. Because [investors and businessmen] then know what ground to go upon.' (*Vallejo v Wheeler* (1774) 1 Cowp 143 153).

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increase in the intensity of trading and the general increase in value have also been seen in the bond market. The private corporate bond market has become increasingly active due to a financial innovation of the 1980s: securitisation,[26] whereby loans are turned into tradable securities.

Having fair financial markets in which the rules are clear, encourages international investment. The South African capital market is now more exposed to international investment. For international investors to be willing to play the South African investment game, however, they must be easily able to ascertain what the rules are. South Africa competes with other jurisdictions to secure capital from sources outside its boundaries. It is important that financial market legislation should, in relation to the qualities of specifically financial market legislation, be internationally competitive.

The two main jurisdictions with which the South African provisions will be compared are the United States and Australia. The United States can be seen as the father jurisdiction of insider trading regulation. As will be shown with specific reference to the definition of insider in the Financial Markets Act, it has fathered some abstruse enactments. It has also been doing so for a long time. Some of the pivotal provisions in its regulation of insider trading date back to 1933. In that year, four years after Black Tuesday,[27] the Securities Act of 1933 was enacted. In the following year, the United States Congress enacted the Securities and Exchange Commission Act of 1934 (SEC Act), which established the Securities and Exchange Commission (SEC) with the purpose of regulating and overseeing the sale of securities in the primary market. The 1934 Act also established the SEC's powers to oversee and regulate trading in securities in the secondary market. The SEC was empowered to pursue civil actions

[26] See N Locke *Aspects of Traditional Securitisation in South African Law* 2010 LLD Thesis University of South Africa.

[27] Black Tuesday refers to Tuesday, 29 October 1929. On that day the 'Great Wall Street Crash of 1929' happened. It is recognised as the most devastating stock market crash in the history of the United States. It marked the beginning of the ten-year Great Depression, which affected all Western industrialised countries.

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or to refer a matter to the American Department of Justice for criminal prosecution. The SEC Act's provisions that deal with insider trading are formulated in broad terms. They prohibit fraudulent and deceitful conduct in relation to trading in securities. The SEC Act also empowered the SEC to promulgate regulations. For the purposes of insider trading, the most important rule made was Rule 10b-5 in 1942.

The United States courts have had much leeway in developing the law of insider trading. A body of jurisprudence has developed, which is valuable, and perhaps indispensable, to any study in the field. That, however, is not to say that it is an example of simplicity, clarity, rationality or even coherence.

The Australian jurisdiction, on the other hand, has not developed the extended body of jurisprudence of the United States. Its legislature has, however, like the South African legislature, enacted new provisions to address insider trading, including important changes to its definition of insider. In contrast to its South African counterpart, at least as far as the definition of insider is concerned, the Australian legislature has made a clean break from the past. It has enacted what amounts to a paradigm shift in its insider trading regulation. The focus has shifted from regulating insider trading to regulating trading on inside information. This is not merely a semantic distinction. The change has an important effect. The focus of the legislative provisions changes. It moves from trading with inside information by certain persons to trading with inside information per se and to the asymmetries of information between traders in the market.

In South Africa the courts have been all but completely bypassed in this branch of the law. The legislature has thus not been constrained by judge-made law, made through the case-by-case, fact-based context in which judgments are written. This has provided the legislature with a clean slate on which to draft our provisions. It has had ample opportunity to formulate a clear piece of legislation based on principle. Yet, and not for a lack of trying, it has failed to

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do so. Rider and French have described an attempt by our legislature at insider trading regulation as an 'unholy jumble and a downright mess'.[28]

To be fair, the South African legislature has not been alone in its travails to find suitable rules to regulate insider trading. Many jurisdictions' attempts have been the object of academic scorn. The regulation of insider trading lends itself to furious debate, even about whether there should be such regulation at all.

Until now, the South African exchanges have also not delivered the same headline grabbing insider trading scandals as has been the case in the United States and, specifically, its New York Stock Exchange. In the United States it has become a highly politicized issue and a bell in the hands of those who profess to set themselves against corporate abuses.[29] South African traders, it has, however, been said, are not saints when it comes to this type of conduct.[30] The

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[28] B Rider & H L French *The Regulation of Insider Trading* (1979) 398.

[29] In the United States insider trading has become an issue that has been said to go far beyond the scope of securities regulation aimed at investor protection. It is said that the regulation has obtained a political dimension with corporate scandals fuelling populist calls on Congress to act. Langevoort writes that: 'Congress had come to see the problem as a manifestation of undue greed among the already well-to-do, worthy of legislative intervention if for no other reason than to send a message of censure on behalf of the American people.'
(D C Langevoort *Insider Trading: Regulation, Enforcement & Prevention* (2009) (*Langevoort on insider trading*) (Rel 7 4/2009) 1–2 et seq.)

[30] In works recounting the history of the JSE (at least up to 1987) very little mention is made of insider trading. Bryant does, however, write:

> One particular area of activity, or non-activity – the attempts to identify insider trading – was to become the perennial target of some of the media's less flattering jeers against the committee's toothlessness. The Undue Price Fluctuations committee has been operating since 1963 and its function is to watch significant share price changes and volumes when no information has been released by the company concerned to warrant them. When these occur, and companies can offer no reasons for them, brokers are instructed to make returns to the Inspectorate Division of all trading in such shares between specified dates. Watertight evidence of insider trading hardly ever comes to light from these returns; not surprising, really, when the large amount of trading in the name of nominee companies is taken into consideration, and when the possible family connections and associates of 'insiders' could follow a spectrum of names as wide as a biographical dictionary. All such inquiries have died a natural death and no prosecution has ever been initiated. The plain fact is that the JSE lacks the power to do this. On those rare occasions when evidence of insider trading seems tangible, the only recourse is to refer the matter to the Registrar of Companies, whose

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small number of successful prosecutions in South Africa for insider trading is to be put down to the difficulties inherent in detecting the offence.[31] Even in the United States, with its highly active SEC, the 'chances of being caught are not great'.[32]

The dearth of successful insider trading prosecutions in South Africa, is certainly not a consequence of a lack of securities trading in the country or that trading in securities is not an established part of its investing community's activities. South Africa has a strong historic connection to share trading.[33] It owes much of its development to that made possible by the capital contributions of many toward reaching one central goal: the *Vereenigde Nederlandsche Geoctroyeerde Oostindische Compagnie* (VOC), the world's first joint-stock company, would never have landed at the Cape had it not been for the power of centralised capital.[34] As the world's first big corporation, it was able to utilise the benefits of economies of scale.[35] It grew out of several smaller local partnerships of merchants who, together with government, contributed toward its share capital. Its operations four centuries ago are a true testament to what is made possible by the pooling of resources.

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function it would be to investigate any apparent breach of the law. (M Bryant *Taking Stock: Johannesburg Stock Exchange – The first 100 years* (1987) 123–124.)

[31] W R Mclucas, J H Walsh & L L Fountain "Settlement of Insider Trading Cases with the SEC" (1992) 48 *Bus Law* 79 84.

[32] *Langevoort on insider trading* (Rel 6 4/2008) 1–9.

[33] The historians write that this history, at least in some way, dates back to the Middle Ages. It is recorded that in 1291 a 'joint stock company' was formed with the object of discovering the Cape of Good Hope. An Italian merchant prince backed by wealthy Italian merchant families is said to have sought to end a Venetian monopoly in trade with the East. They are said to have passed the Cape, but their ships sank off the East Coast of Africa. (See E Rosenthal *On 'Change through the Years'* (1968) 9–10.

[34] The United East India Company or 'Vereenigde Oost Indische Compagne' was founded in the Netherlands. It grew out of several smaller local partnerships of merchants in the major cities of the Low Countries, all of whom contributed to the Compagne's share capital. The government, too, contributed a hefty sum. An investment in the VOC seems to have been one well made. It is said that '[n]ever in history has a company paid such vast returns over so long a period'. (E Rosenthal *On 'Change through the Years'* (1968) 11.)

[35] A M Carlos & S Nichols "'Giants of an Earlier Capitalism': The Chartered Trading Companies as the World's first Multinationals" (1988) 62 *Business History Review* 398.

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Around 1600 there were some six fledgling companies operating out of all the major Dutch ports who set themselves the trading of East Indian produce as goal. The entities were granted a limited term, usually only for one voyage, after which investors' investments were repaid.[36] These arrangements were, however, not sufficient to found the necessary bases truly to take the lead in trade with the East. Consequently, the Dutch *Staten-Generaal* proposed that these smaller entities be merged. The result was the VOC. It was chartered in 1602 to enjoy a monopoly on all Dutch trade east of our Cape and West of the Straits of Magellan.[37] All this was made possible by the community, who made available their funds in return for equity and the promise of profit sharing.

Subscription to the VOC's capital was open to all residents of the United Provinces. Merchants, artisans and servants alike acquired shares and took part in what was largely a novel idea. The investments ranged in size. In Amsterdam alone there were 1 143 subscribers, only 10 of whom invested more than 10 000 guilders.[38] It was not long after the world's first joint-stock company was born that its first true stock market saw the light of day.[39] The ownership of shares required a secondary market for those shares to be sold. In 1607 already one-third of the VOC's shares had changed hands. Further, as a result of the fact that the company's share register was opened only once a month, a market for futures soon developed.[40]

The first stock exchange was opened in Amsterdam in the early 1600s. Initially, mostly VOC shares were traded. The size of stock exchanges grew as the state granted corporate status to a growing number of companies whose activities were considered to be in the public interest. The advantage to these new corporations with their public interest purpose was clear: the

[36] N Ferguson *The Ascent of Money – A Financial History of the World* (2008) 129.
[37] Ibid.
[38] Ibid. 130.
[39] Ibid. 132.
[40] Ibid. 133.

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limited liability enjoyed allowed the corporation to bring together the capital of a much larger number of shareholders than unincorporated partnerships could.

On South African soil companies were floated and shares were traded at the Cape from the late eighteenth century onwards.[41] South Africa experienced its first share boom in the 1850s brought about by the discovery of copper in the Namaqualand.[42] The boom, as booms have become known to do, drew in almost all who had a penny to invest. There were severe losses in what proved to be an ill-conceived venture. Importantly, however, the losses seem to have been equally felt by all who invested.[43]

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[41] E Rosenthal *On 'Change through the Years'* (1968) 15–30.

[42] Ibid. 31. Rosenthal quotes RW Murray:

> It was the time of the Namaqualand copper mining mania, and I was reminded of it when the late Transvaal gold mining mania was at its height, and as seen from the Barberton mountain range and the Rand reefs, history was repeating itself with great fidelity. The scrip thermometer showed about the same degree of mad fever in both cases. In each case prospectors, company promoters and speculators went to working the same way, sinking shafts to add to their own pockets, raising capital on "centres", which were nowhere to be seen but upon the diagrams of draftsmen, drawn upon broad sheets of drawing board, being facsimiles of nothing that had the colour of metal. . . . New companies sprang up more suddenly than mushrooms – scrip flew around with a deftness that no bird could keep up with, and promissory notes flew with all the airiness of kites. Promises to pay, made in Stephan's Jet Black Ink and written with Gillott's Seals, passed the currency with a readiness the Bank of England could not rival.

[43] R W Murray writes:

> The mania was so contagious as any other disease. It infected every class; even the clergy were not more exempt than they were here during the gold and diamond share booms; officials of every department of the service were bitten. Even that man of huge intellect, Mr. Porter, the Attorney-General, went into it ten-thousand strong, and became director of companies which hadn't enough copper to make a George III penny piece. He, of course, thought everything was all right. His example encouraged others, and he came out of his scrip spec. lighter in pocket by thousands of pounds than he went into it; smaller men came out stumped. One or two committed suicide. More than one army pensioner lost not only his available property, but his pension into the bargain. A crowd went through the insolvency court and, of the crown of miners and managers sent down by the companies, not a few had to remain there with no neighbours but penguins and ostriches, and nothing but penguin and ostrich eggs to subsist on. (As quoted by Rosenthal *On 'Change through the Years'* 33.)

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Shortly after the Namaqualand copper fiasco, it became possible for limited liability companies with freely transferable shares to be incorporated in South Africa.[44] The stage was set for the escalation in share trading, which was to be brought about by the discovery of diamonds and gold. The discoveries of these minerals led to the floatation of many companies. As the number of companies grew, so did the number of investors and their portfolios. The need to establish places where people could meet to trade their shares also grew. Ultimately, the Johannesburg Stock Exchange (JSE) was founded. Although not South Africa's first,[45] it was for a long time South Africa's only stock exchange.[46]

The JSE was also for a long time allowed to regulate its own affairs. It was not until the enactment of the Stock Exchanges Control Act[47] in 1947 that Parliament imposed its legislative authority on the JSE. The Act required the exchange to be licensed and it required all stockbrokers to become licensed members of the stock exchange. The internal conduct of the

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[44] Act 23 of 1861 was enacted '[t]o limit the liability of members of certain joint stock companies'. The preamble and the first section read as follows:

> Whereas it is expedient to enable members of certain joint-stock companies to limit the liability for the debts and engagements of such companies to which they are, or may be, subject: Be it enacted by the Governor of the Cape of Good Hope, with the advice and consent of the Legislative Council and House of Assembly thereof, as follows:— 1. The term "joint-stock company" in this Act shall mean every partnership whereof the capital is divided, or agreed to be divided, into shares, and so as to be transferable without the express consent of all the partners; and also every partnership which had at its formation, or by subsequent admission, shall consist of more than twenty-five members.

[45] The Johannesburg Stock Exchange was founded on 8 November 1887. The first stock exchange in South Africa was the Kimberley Share Exchange, Broking and General Agency Company Limited, brought into being on 26 August 1880. (Rosenthal *On 'Change through the Years'* 58) It was followed by the Kimberley Royal Stock Exchange and Barnato's Exchange and the Mutual Share and Claim Exchange and Commercial Agency Company Limited in the 1880s. (Ibid. 57–74). Other notable stock exchanges were the De Kaap Stock Exchange in Barberton (Ibid. 75–87), the Klerksdorp Stock Exchange (*Ibid* 88–96), the Potchefstroom Stock Exchange and Club Company Limited (Ibid. 97–91), the Pietermaritzburg Stock Exchange (Ibid. 102–111), the Durban Stock Exchange (Ibid. 112–117), the Cape Town Stock Exchange (Ibid. 118–129), the South African Share and Claim Exchange (Ibid. 130–133) and the Rand Stock Exchange (Ibid. 188–190).

[46] The JSE's only surviving competitor for some time, the Union Stock Exchange, was closed in 1958 after its membership fell below the minimum requirement stipulated in the Stock Exchange Control Act 7 of 1947. Two new exchange licences were granted in 2016. Further licence applications are being considered at the time of writing.

[47] Stock Exchange Control Act 7 of 1947.

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exchange was, however, to be regulated by its own rules and regulations. The Act was amended numerous times. Not one of the amendments related to insider trading. On it the Stock Exchanges Control Act said nothing. It seems at that point the legislature was not too concerned by some traders in the market enjoying unfair advantages.

The South African legislature's first steps toward finding a suitable legislative instrument for the regulation of insider trading were not taken in the Stock Exchange Control Act, the piece of legislation intended to regulate stock exchanges and the trading of securities. They were taken in the Companies Acts, Acts primarily aimed at regulating the divide between ownership and control. The South African legislature saw insider trading as a wrong perpetrated primarily by directors against shareholders, not share traders *inter se*. The provisions relevant to insider trading remained in the Companies Acts,[48] until the enactment of the Insider Trading Act.[49] Subsequently, the provisions were included in the South African financial market Acts: First in the Securities Services Act[50] and then in the current Act.[51]

The first provision that is relevant is to be found in the 1926 Companies Act.[52] It must be seen in its historical context. In England both the Cohen and the Millin committees had found that requiring 'directors' to disclose their dealings in a company's shares would be the best safeguard against insider trading.[53] The English legislature made the necessary enactments. The South African legislature followed suit. In 1952, section 70*nov* was inserted into the 1926 South African Companies Act. Its focus was again squarely on directors. It required all

48 Companies Act 46 of 1926 and Companies Act 61 of 1973.
49 Insider Trading Act 135 of 1998.
50 Securities Services Act 36 of 2004.
51 Financial Markets Act 19 of 2012.
52 Companies Act 46 of 1926. See D Botha "Control of Insider Trading in South Africa: A Comparative Analysis" (1991) 3 *SA Merc LJ* 1 4. The author is incorrect in stating that section 233 in the Companies Act 61 of 1973 is the first provision that is relevant to insider trading in South Africa.
53 See the Cohen Committee Report at par. 86 and the Millin Committee Report at par. 141–143.

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companies to keep a register of directors' share and debenture holdings, which had to include the details of all transactions that affected a change in them.[54]

In 1970 the Van Wyk De Vries Commission found the provisions of section 70*nov* to be ineffective. The Commission argued strongly against deregulation.[55] According to the Commission the question was not whether the practice should be regulated, but what form the regulation should take.[56] Its suggestions were enacted in the 1973 Companies Act.[57] The focus remained on directors, while the provisions still required a register to be held that disclosed their interests in the shares and debentures of the company.[58] It also went further. The legislature made it an offence to trade on certain information that, on being made public, would materially affect the prices of the shares of a company.

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[54] Companies Act 46 of 1926 s 70*nov*. The section reads in relevant part:

(1) Every company shall keep a register in which there shall be recorded as respects each director of the company, within seven days of the receipt of the relevant notice under subsection 11, the number, description and amount of any shares in or debentures of the company or any other body corporate (being the company's subsidiary or holding company, or a subsidiary of the company's holding company) which are held by or in trust for him or of which he has any right to become the holder whether on payment or not: Provided that the register need not include shares in or debentures of any body corporate which is the wholly owned subsidiary of another body corporate, and for this purpose a body corporate shall be deemed to be the wholly owned subsidiary of another if it has no members but that other and that other's wholly owned subsidiaries and its or their nominees.

. . . .

(11) It shall be the duty of every director of a company, and of every person deemed to be a director under paragraph (a) of subsection (10), to give notice to the company with respect to any shares or debentures held by him or in trust for him or of which he has any right to become the holder at the commencement of this section, within twenty-one days after the said commencement, and with respect to any shares and debentures of which he becomes the holder in trust for him or of which he acquires the right to become the holder after the said commencement, within twenty-one days after the date upon which he acquires the said right, as the case may be, of such matters relating thereto as may be necessary for the purposes of this section.

[55] Van Wyk De Vries Commission 85.

[56] Van Wyk De Vries Commission 85.

[57] Companies Act 61 of 1973.

[58] Companies Act 61 of 1973 s 230.

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For the first time in South Africa, insider trading by directors became a criminal offence. The enactments rightly did not escape criticism. The provisions were said to be 'innocuous'[59] and Rider and French subjected section 233,[60] which contained the main substantive provisions, to harsh criticism.[61] In 1989 the provisions were repealed and substituted.[62] This was to be only another step in a drawn-out process of trial and error leading up to the enactment of the Financial Markets Act's present provisions.

The 1989 amendments were not, however, merely another attempt at regulating insider trading. The amendments also provided for the establishment of a Securities Regulation Panel,[63] with the powers of subpoena and interrogation.[64] Insider trading was retained as a criminal offence, while section 441 significantly increased the penalties applicable to contraventions. Substantively, the provisions completely broke away from those that had gone before. They were now squarely based on Rule 10b-5 in the United States, leaving South Africa with a general anti-fraud provision.[65]

There was also an important shift in focus. Directors were no longer the only persons capable of being held liable for insider trading. All people who received inside information from anyone in the main defined group of prohibited traders, so-called 'tippees', now fell foul of

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59 Jooste (2000) *S African LJ* 284.

60 Section 233 reads:

> Every director, past director, officer or person who has knowledge of any information concerning a transaction or proposed transaction of the company or of the affairs of the company which, if it becomes publicly known, may be expected materially to affect the price of the shares or debentures of the company and who deals in any way to his advantage, directly or indirectly, in such shares or debentures while such information has not been publicly announced or a stock exchange or in a newspaper or through the medium of the radio or television, shall be guilty of an offence.

61 Rider & French *The Regulation of Insider Trading* 398.

62 Companies Amendment Act 78 of 1989.

63 Companies Act 61 of 1973 s 440B.

64 Companies Act 61 of 1973 s 440D.

65 S M Luiz 'Insider Trading: A Transplant to Cure a Chronic Illness' (1990) 2 *SA Merc LJ* 59 and see *Texas Gulf Sulphur Co* 401 F2d 833 (1968) 848.

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the prohibition. These amendments were also not well received.[66] Indeed, they were found to be wholly inappropriate[67] and were repealed without ever coming into operation.[68]

A new section 440F was enacted.[69] Again, a complete break was made with the previous provisions. In hindsight, the new section 440F provided a simple and logical solution to a problem area of the law, inclined to complexity. The section provided that any person trading with inside information would be guilty of an offence if that person knew that the information being used was not acquired through legal means. Essentially, the new section did away with circumscribing a group of persons who were not allowed to trade with inside information. It rather prohibited all trading on inside information.[70] It also provided for a more expansive definition of inside information.[71]

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66 See R Du Plessis "Binnekennistransaksies: `n Evaluasie van die Huidige Statutêre Bepalings" (1995) 7 *SA Merc LJ* 19 20, Luiz 1990 *SA Merc LJ* 66 and R Jooste "Insider Dealing in South Africa" (1990) 107 *S African LJ* 588.

67 Ibid.

68 Companies Second Amendment Act 69 of 1990 s 1–2.

69 Companies Second Amendment Act 69 of 1990 s 1–2.

70 Section 440F(1) provided:

> Any person who, whether directly or indirectly, knowingly deals in a security on the basis of unpublished price-sensitive information in respect of that security, shall be guilty of an offence if such person knows that such information has been obtained—
> (a) by virtue of a relationship of trust or any other contractual relationship, whether or not the person concerned is a party to that relationship; or
> (b) through espionage, theft, bribery, fraud, misrepresentation or any other wrongful method, irrespective of the nature thereof.

71 Section 440F(2) provided:

> For the purposes of this section—
> (a) 'unpublished price-sensitive information', in respect of a security, means information which—
> (i) Relates to matters in respect of the internal affairs of a company or its operations, assets, earning power or involvement as offeror or offeree company in an affected transaction or proposed affected transaction;
> (ii) Is not generally available to the reasonable investor in the relevant market for that security; and
> (iii) would reasonably be expected to affect materially the price of such security if it were generally available;

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However, as there had still not been a single successful prosecution for insider trading[72] at a time when South Africa was experiencing a 're-integration into the international financial markets' and the government had a 'desire to create an environment conducive to foreign investment', the King Task Group on Insider Trading found it necessary to dedicate an entire Act exclusively to insider trading.[73] The legislature gave effect to its proposals. The Insider Trading Act came into operation in January 1999. The Insider Trading Act prohibited insider trading also in other financial instruments apart from shares and it provided for a civil remedy for those harmed by the prohibited conduct.

The King Task Group's report is still of importance even though the insider trading provisions were subsequently moved to the Securities Services Act[74] and ultimately to the Act. The definitions have largely stayed the same since the enactment of the Insider Trading Act. The changes will be discussed in due course. More importantly for this first part of the thesis is, however, the fact that the King Task Group saw the reason for prohibiting insider trading, albeit by implication, to be to promote the integrity of the capital markets. This is in keeping with the objectives of the current Act.

(b) 'generally available' means available in the sense that such steps have been taken, and such time has elapsed, that it can reasonably expected that such information is not information as referred to in subparagraph (ii) of paragraph (a).

See D Botha (1991) *SA Merc LJ* 12; Jooste 1990 *S African LJ* 608; and Luiz 1990 *SA Merc LJ* 332.

[72] R Jooste "The Regulation of Insider Trading in South Africa – Another Attempt" (2000) 117 *S African LJ* 284.

[73] Final Report by The King Task Group into insider trading legislation, 21 October 1997 (King Final Report).

[74] Act 36 of 2004. The Securities Services Act came into operation in February 2005. It repealed the Stock Exchange Control Act 1 of 1985, the Financial Markets Control Act 55 of 1989, the Custody and Administration of Securities Act 85 of 1992 and the Insider Trading Act 135 of 1998. The trading on inside information provisions were found in chapter 7 of the Act under the heading 'Market Abuse'. The Act purported to increase confidence in South African financial markets by ensuring that securities services were provided in a fair, efficient and transparent manner and contributed to the maintenance of a stable financial market environment (s 2(a)(i)–(ii)).

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The current Act includes express objectives. They provide some of the context in which the definitions of 'inside information' and 'insider' should be interpreted. The Act, it is said, is legislation with the purpose of regulating the South African financial markets.[75] Section 2 of the Act provides as follows:

> This Act aims to—
>
> (a) ensure that the South African financial markets are fair, efficient and transparent;
>
> (b) increase confidence in the South African financial markets by—
>
> (i) requiring that securities services be provided in a fair, efficient and transparent manner; and
>
> (ii) contributing to the maintenance of a stable financial market environment;
>
> (c) promote the protection of regulated persons, clients and investors;
>
> (d) reduce systemic risk; and
>
> (e) promote the international and domestic competitiveness of the South African financial markets and of securities services in the Republic.

These lofty ideals cannot be faulted, but they are not where the Act's problems lie.

It will be argued that the Act's definitions of 'inside information' and 'insider' fail to adhere to the single theory of wrongfulness in respect of insider trading that will best give effect to the legislature's stated objectives. Once that single theory of wrongfulness is identified, the definitions can be simplified. It will also ensure that the South African insider trading legislative provisions reflect the paradigm shift occurring in insider trading law, especially notable in Australia. This shift includes, but is not limited to, an increasing tendency to view trading on inside information as a market problem rather than wrongful conduct perpetrated exclusively by directors or officers of issuer companies.

[75] See the Preamble to the Act.

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2 THEORIES OF REGULATION: TOWARDS A MARKET WRONG

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2 1 Introduction

It is now commonplace for the citizens of many countries to invest substantial portions of their savings, including their retirement moneys, in securities.[76] This makes the regulation of the financial markets of vital importance. In this chapter the bases for regulating insider trading, a form of financial market abuse, will be examined. The basis for the regulation of insider trading in South Africa will also be identified.

Financial markets are open to abuse. The Financial Markets Act was, for instance, enacted shortly after the global crisis in the financial services industry sparked questions on the advance selling of securities (to unwitting purchasers) before the collapse of some of the world's most prominent financial institutions.[77] At times there somewhat ironically seems to be no fairness in the trading of, among other instruments, equity.[78] This presents a danger to financial markets: they could be perceived as playing fields for an unfair game. For people to be willing to participate in these markets, that cannot be the case.[79] It is generally accepted that public confidence in financial markets is essential if they are to fulfil their important role in capitalist economies.[80] The objectives of the Financial Markets Act most relevant to the regulation of insider trading are thus ensuring that financial markets are fair and increasing confidence in the South African financial markets. These objectives are intertwined. When markets are perceived as fair, the public will have confidence in them. Fairness, it is said, is central to the integrity of, or the confidence people have in, the financial markets.[81]

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[76] B M Smith *A History of the Global Stock Market* (2004) 6.

[77] *Langevoort on insider trading* (Rel. 7 4/2009) 1–4.

[78] The word 'equity' derives from the Latin *aequitas*. It, in turn, derives from *aequus*, meaning even or fair. (Smith *A history of the global stock market* 1.)

[79] S G Cecchetti *Money, Banking and Financial Markets* 2 ed (2008) 7.

[80] Cecchetti *Money, Banking and Financial Markets* 189.

[81] See Scott (1980) *J Legal Stud* 804 and the 'fair play' rationale. Also see how this rationale runs into the 'integrity of the capital market' argument. Also see L Herzel & L Katz "Insider Trading: Who

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Insider trading, it is argued, causes damage to an economy as it erodes public confidence in the financial markets.[82] The regulation of trading on inside information, on the other hand, is said to further investor confidence in the financial markets.[83] At the least, as Loss observes, when it comes to investor confidence and insider trading, the legal principle that justice must not only be done, it must be seen to be done, applies.[84] Especially perceived unfettered insider trading, it is said, has a negative impact on the public's confidence in the financial markets.[85] Calls for the stricter regulation of insider trading are thus normally made by emphasising that trading on inside information threatens the very core of the securities markets as it undermines the public's confidence in them.[86] In *R v Glynatsis*[87] the New South Wales Supreme Court captured the idea as follows:

> The acquisition or disposal of financial products by people having the unfair advantage of inside information is criminalised because it has the capacity to unravel the public trust which is critical to the viability of the market. It is, as previously observed by this Court, a form of cheating.[88]

In *Spector Photo Group NV. Chris Van Raemdonk v Commissie Voor Het Bank-Fanancie- En Assurantiewezen (CBFA)*,[89] the European Court of Justice in turn held as follows:

Loses?" (1987) *Loyds Bank Review* 15; and V Brudney "Insiders, Outsiders, and the Informational Advantages under the Federal Securities Laws" (1979) 93 *Harvard LR* 322.

82 For authors arguing that insider trading is not damaging to capital markets see J D Cox "Insider Trading and Contracting: A Critical Response to the 'Chicago School'" (1986) 628 *Duke LJ* 628; H Manne "Insider Trading and the Law Professors" (1969–1970) 23 *Vand L Rev* 547; H G Manne "Insider Trading and the Administrative Process" (1966–1967) 35 *Geo Wash L Rev* 473. However, the majority of economists and financial experts agree that insider trading has a negative impact on a capital market and should be prohibited. See M J Chimel "The Insider Trading and Securities Fraud Enforcement Act of 1988: Codifying a Private Right of Action" (1990) 3 *U Ill L Rev* 645; S D Klein "Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence" (1988) 16 *Hofstra L Rev* 665; S Bainbridge "The Insider Trading Prohibition: A Legal and Economic Enigma" (1986) 38 *Fla L Rev* 35; H Wu "An Economist looks at section 16 of the Securities and Exchange Act of 1934" (1968) 68 *Colum L Rev* 260.

83 Botha (1991) *SA Merc LJ* 4.

84 L Loss "The fiduciary concept as applied to trading by corporate 'insiders' in the United States" (1970) 33 *Mod L Rev* 84 86.

85 Schotland (1967) *Va L Rev* 1440.

86 W R McLucas, J H Walsh & L L Fountain "Settlement of Insider Trading Cases with the SEC" (1992) 48 *Bus Law* 79 80.

87 [2013] NSWCCA 131.

88 Par 79.

89 [2009] EUECJ C – 45/08 (23 December 2009) par. 50–52.

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> [I]nside information grants the insider in possession of such information an advantage in relation to all the other actors on the market who are unaware of it. It enables that insider, when he acts in accordance with that information in entering into a transaction on the market, to expect to derive an economic advantage from it without exposing himself to the same risks as the other investors on the market. The essential characteristic of insider dealing thus consists in an unfair advantage being obtained from information to the detriment of third parties who are unaware of it and, consequently, the undermining of the integrity of financial markets and investor confidence.

The fundamental idea is not a novel one: people generally do not want to take part in activities if they believe their fellow participants to be cheating.

It is to be noted, however, that notions such as the integrity of the capital markets and confidence in the financial markets, and the large role they play in securities regulation, have not been without their critics. Manne harshly questions the merits of recognising something like the 'integrity of the capital market' and states that, apart from it being a 'falsifiable proposition, it is devoid of the scantest economic or empirical content.'[90] Langevoort has argued that the investor confidence argument is a founding myth of securities regulation.[91] There are also commentators who assert that notions of fairness have no place in legal arguments for the regulation of insider trading. They say that the bare assumption that insider trading is unfair does not offer any great assistance in assessing whether insider trading should be prohibited or, indeed, in formulating prohibitions on insider trading.[92] Whether inside information trading causes damage to the financial markets at all has also been questioned. It is argued that regulating inside information trading bears a higher cost than a laissez faire approach.[93] This last-mentioned argument is, however, of little import to this thesis. The

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90 H G Manne "Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark" (2005) 31 *J Corp L* 167 168 note 5. Manne goes on to call the argument 'enormously important in the propaganda campaign the SEC has waged for years to demonize insider trading'.

91 D C Langevoort "Rereading Cady Roberts: The Ideology and Practice of insider Trading Regulation" (1999) 99 *Colum L Rev* 1319.

92 Rider & French *The Regulation of Insider Trading* 1.

93 U Bhattacharya & L H Daouk "The World Price of Insider Trading" (2002) 57 *J Fin* 75. Also see L N Beny "Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence" (2005) 7 *Am L & Econ Rev* 144 and L N Beny "Do Investors in Controlled Firms Value Insider Trading Laws? International Evidence" (2007–2008) 4 *J L Econ & Pol'y* 267.

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choice to regulate has been made by the South African legislature. It is not the focus of this thesis. The implementation of the choice is.

Fairness, and specifically the assertion that it must be the basis for the formulation of legal rules, is not so easily dismissed in South African law. It, for example, plays an important role in the analogous South African legal field of unfair competition. In *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd*[94] Van Dijkhorst held that that the test to be applied in determining whether the conduct complained of was unlawful was an

> objective one of public policy, i.e. the general sense of justice of the community, the boni mores manifested in public opinion. In determining and applying this norm in a particular case, the interests of the competing parties have to be weighed, bearing in mind also the interests of society, the public weal. As this cannot exist in vacua *the morals of the market place, the business ethics of that section of the community where the norm is to applied are of major importance in its determination.*"[95] (Emphasis added.)

And, in *Schutz v Butt*[96] it was held that in judging fairness and honesty, the *boni mores* and the general sense of justice of the community must be taken into account.[97]

Fairness has long been a subject of legal and legal philosophical writing. Aristotle developed the notion of a fair price for things bought and sold.[98] St Thomas Aquinas declared that it is improper to 'sell dearer or buy cheaper than a thing is worth'.[99] Cicero also used the notion of fairness in his dealing with something akin to trading with inside information. He posed especially one hypothetical situation, which is still being used to explore the difference

94 1981 (2) SA 173 (T).
95 Ibid. 188G.
96 1986 (3) SA 667 (A).
97 See also *Lorimar Productions Inc and Others v Sterling Clothing Manufacturers (Pty) Ltd* 1981 (3) SA 1129 (T).
98 Smith *A History of the Global Stock Market* 9.
99 A E Monroe *Early economic thought: Selections from economic literature prior to Adam Smith* (1934) 15.

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between moral blameworthiness and that which should carry legal sanction. It also illustrates the fluidity of the concept of fairness.

Cicero used the stoic philosophers Antipater and Diogenes to tell a story of a merchant who was importing grain from Alexandra to Rhodes. The facts are comparable to the typical insider trading scenario. Famine prevailed in Rhodes, but not in Alexandra. A merchant importing grain to Rhodes could expect to realise a healthy profit. The merchant knows, however, that, although his ship is first to arrive in Rhodes, there are many ships on their way, soon to reach its shores. He also knows that if the people of Rhodes were to know of those ships, the price they would offer for his grain would be much less. Cicero poses the question: '[I]s he to report the fact to the Rhodians, or is he to keep his own counsel and sell his own stock at the highest market price?'[100] He let Antipater argue for full disclosure and Diogenes for the moral right to silence:

> "I have imported my stock," Diogenes' merchant will say; "I have offered it for sale; I sell at a price no higher than my competitors – perhaps even lower, when the market is overstocked. Who is wronged?"
>
> "What say you?" comes Antipater's argument on the other side; "It is your duty to consider the interests of your fellow men and to serve society; you were brought into the world under these conditions and have these inborn principles which you are duty bound to obey and follow, that your interest shall be the interest of the community and conversely that the interest of the community shall be your interest as well; will you, in view of all these facts, conceal from your fellow-men what relief in plenteous supplies is close at hand for them?"
>
> "It is one thing to conceal," Diogenes will perhaps reply; "not to reveal is quite a different thing. At this present moment, I am not concealing from you, even if I am not revealing to you, the nature of the gods or the highest good; and to know these secrets would be of more advantage to you than to know that the price of wheat was down. But I am under no obligation to tell you everything that it may be in your interest to be told."
>
> "Yes," Antipater will say, "but you are, as you must admit, if you will only bethink you of the bonds of fellowship forged by nature and existing between man and man."

[100] M Cicero *Cicero De Officiis. With a translation by Walter Miller* (1913) 319–323.

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> "I do not forget them," the other will reply; "but do you mean to say that those bonds of fellowship are such that there is no such thing as private property? If that is the case, we should not sell anything at all, but freely give everything away."

Cicero supports Antipater. He writes that it was the duty of the grain-dealer not to keep back the facts from the Rhodians. He relies on the existence of a bond of fellowship between all people that has wide application and unites people. He sees the failure to disclose as the conduct of a man who is not candid, sincere, straightforward, upright or honest, but rather one who is shifty, sly, artful, shrewd, underhand, cunning, fraudulent and deceitfully subtle. He asks rhetorically, whether it is not better for a person not to subject himself to all these terms of reproach. According to Cicero, it is against nature for one man (a neighbour) to take advantage of his fellow man's ignorance.[101]

Hugo De Groot considered Cicero's grain merchant example. De Groot makes a distinction about circumstances (or information) that do not affect the thing itself. To give that information to your fellow man, says De Groot, may be kind and laudable. Not to do so may violate the 'rule of charity'. However, says De Groot, the omission would not be unjust. It would not be repugnant to the rights of the counterparty. He emphasises the fact that the seller brought his goods to the market. The seller chose to offer them for sale. It is the seller who chose the price and the point when he set it. He did not sell his goods at a greater price than for similar products at the time of the sale. He might even have sold it at a cheaper price. In that sense, in as far as the information did not relate to the thing itself, no one is wronged. As such, concludes De Groot, Cicero's rule is not to be applied too widely. Only the concealment of facts that affect the thing itself should be prohibited. He argues that in general Cicero's conclusion, that the merchant's conduct concerning the information about the other ships,

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[101] Ibid.

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amounts to wrongful concealment, is not correct. Cicero's conclusion would be correct only in as far as the concealment relates to the thing itself.[102]

Pufendorf[103] largely agrees with De Groot. He writes that the merchant did not act unjustly in saying nothing of the ships that were coming. He submits that justice requires only the disclosure of facts that concern the thing itself. For instance, where the seller is to sell a house by reason of it being infected and it had been commanded by a magistrate to be demolished, those would be facts that a seller of the house has to disclose to a prospective buyer.[104] According to Pufendorf, nothing of this nature was concealed by the grain merchant. The goodness of the corn was clear for all to see. At the time of the contract, it was worth as much as it was sold for, notwithstanding the fact that it was likely to be worth less in little time.[105] Pufendorf, like De Groot, looks to the rights of the purchasers in the market. He submits that the Rhodians had no right, properly speaking, to obtain the information from the merchant as there existed at the time of the sale no 'bargain' between them. As I interpret Pufendorf, the reasons for his opinion include a recognition of the fact that, at the time of the sale, there was no overarching or other agreement (other than the eventual agreement of sale) between the purchasers and the merchant.

Pufendorf also goes further than De Groot. He recognises, to start, that to ask what the law of courtesy and good nature forbids is wholly different from asking whether something must be prohibited by law. He reasons that not even good nature obliges one person to do another man a courtesy gratis, except when that person is in desperate want of it.[106] This was not so in the case of the Rhodians; they wanted corn, but not money. They were famous among the

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[102] H Grotii *De Jure Belli accompanied by an abridged translation by William Whewell* Vol 1 (1853) Book II chapter XII par IX (158–160).

[103] S Pufendorf *On the Law of Nature and Nations done into English by Basil Kennett* (1729) Book V Chapter III ii–iii (479–480).

[104] Ibid.

[105] Ibid.

[106] Ibid.

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Athenians for their riches.[107] Besides, says Pufendorf, a man is not obliged to do a kindness, when 'tis like to tend more to the detriment of the giver than the benefit of the receiver'.[108] In this case, the merchant would have lost more than the purchasers would have received. For if the merchant sold to many purchasers at his price, each purchaser would have borne only a slight loss. If one man had bought the lot, says Pufendorf, his loss is to be put down to avarice. And, it seems, that he incurred a large loss is just.[109]

Pothier wrote about the grain merchant under the heading 'whether good faith obliges the seller, at least in the forum of conscience, not to suppress any of the extrinsic circumstances, which the buyer has an interest in knowing'.[110] According to Pothier, the question belongs only to the forum of conscience. For the buyer should not have a case against the seller in a court of law.[111] The law of contract obliges a seller to do nothing more than to cause the buyer to know the thing for what it is. He may, however, not conceal any of the merx's defects and he is to sell it for the price that it bears at the time of the contract.[112] He does not commit any injustice by selling for that price, notwithstanding the fact that he knows that price that could be realised for the thing will be much lower in due course.[113] The seller is not obliged to tell the purchaser about the circumstances that could cause the lowering in price. The buyer also has no right to require this information.[114] In agreement with Pufendorf, Pothier writes that if the seller were to provide the information to the purchaser, it will be 'a gratuitous act of beneficence',[115] which he is under no obligation to exercise, except in favour of those who are 'in need'.[116] The Rhodians were not in that situation and had money to purchase that which

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107 Ibid.
108 Ibid.
109 Ibid.
110 R J Pothier *Treatise on the contract of sale translated from the French by L S Cushing* (1840) Part Second Article III Par 242 (147–150).
111 Ibid.
112 Ibid.
113 Ibid.
114 Ibid.
115 Ibid.
116 Ibid.

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the merchant sold to them.[117] Pothier also makes a new point: the profit the merchant made by selling his corn at its present value, though he knew that it would soon be worth much less, was not an unjust profit. This is so, says Pothier, as it was a just reward for the diligence that enabled him to arrive at the market first, and for the risk that he ran of losing his merchandise, if any of the accidents, to which he was exposed, should have prevented his arrival at the time.[118]

As a matter of interest, Pothier's opinion changes when the hypothetical sale and the arrival of the boats, and the subsequent fall in the price for corn, are separated by only two days. He writes:

> Notwithstanding these reasons and authorities, I should have some difficulty in excusing, from charge of injustice, the profit derived by a seller from the concealment of some fact, which must cause the price to fall, when such diminution of the price must be very considerable, and must happen at the end of a very short interval of time, such as the knowledge which the merchant had, that there was a fleet laden with corn ready to enter the harbour of Rhodes in a few days. . . .[119]

I struggle to make sense of this statement by Pothier. It seems to me not to be based on any principle or to be part of the formulation of any principle. If the statement is meant as the formulation of an exception to a rule, I am unable to find the principle underlying the exception. How could the difference in the size of the loss or the extent of time between the sale and the fall in price make any difference to the simple question of whether a right or an obligation is owed to disclose the information or not to trade while his counterparties are unaware of it? It should not.

Much like the Rhodians, the insider's counterparty is, at the point of sale, happy to accept the bargain as it stands. He receives the price he asks for or the number of securities for the price he tenders. It is only after the transaction that, much like the Rhodians again, he realises that

[117] Ibid.
[118] Ibid.
[119] Ibid.

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he has made a bad bargain. Our courts have thus come close to comparing an insider trading-like scenario with the subject of the Rhodian example. In *Pretorius v Natal South Sea Investment Trust*[120] Vieyra J was confronted with directors of a company who sold shares without disclosing certain information about those shares to their prospective shareholders.[121] The analogy was drawn between a latent defect (where the omission to disclose gives rise to the *actio redhibitoria*) and the situation where the seller of shares, in the circumstances of the case a director, holds non-public information that, if generally known, would detrimentally affect the market price of the share. The court found that the case before it encompassed an involuntary reliance of one party on the frank disclosure of another. A duty to disclose was recognised as the buyer's 'right to have such information communicated to him would be mutually recognised by honest men in the circumstances'.[122] *Pretorius*,[123] however, dealt with an over-the-counter sale of shares.[124] Therein also lies the difference between insider trading in the financial markets and the Rhodian example. First, the example does not tell us whether the Rhodians always bought grain at that market or whether and how the fact that they were duped by the first boat, affected their perceptions of the market for grain in general. Second, it is not known whether the Rhodians had other markets where they could purchase grain.

The financial market is of course not a case of a once-off sale, but is a continuous market. In addition, it provides one place among many where people can invest. An ordinary member of the public faces a choice between keeping his earnings in a cash deposit, or rather keeping it in other stores of value such as shares, houses, cars (which are examples of equity investments) or bonds (an example of a debt investment). The latter options should be preferable to a prospective investor as stores of value in which to keep his earnings, as they offer to provide

[120] *Pretorius v Natal South Sea Investment Trust Ltd* 1965 (3) SA 410 (N) 418.
[121] Likely because of doubt whether directors owe fiduciary duties to prospective shareholders.
[122] *Pretorius v Natal South Sea Investment Trust Ltd* 1965 (3) SA 410 (W) 417. The court quotes M A Millner "Fraudulent Non-Disclosure" (1957) 74 *S African LJ* 189.
[123] *Pretorius v Natal South Sea Investment Trust Ltd* 1965 (3) SA 410 (N) 418.
[124] Also see R Du Plessis "Binnekennistransaksies by oornames en samesmeltings" (1989) 1 *SA Merc LJ* 48 footnote 8.

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more benefits than keeping his earnings in cash. For instance, bonds offer him the potential to earn more interest than keeping his earnings deposited at a bank, whereas stocks provide him with the opportunity to realise an appreciation in nominal value.[125] Stocks and bonds, stores of value, hold the potential to generate larger increases in value and, therefore, larger increases in an owner's wealth than other forms in which value can be stored (such as cash). These higher payoffs are economically recognised as compensation for the larger risk the investor bears.[126] The benefits provided by the financial market to investors can, however, be outweighed by factors that heighten the risks in trading in the financial markets. Trading on inside information would be one such factor.

If the financial markets are seen as places where bad bargains frequently occur, indeed, where it is impossible to strike a good bargain without inside information, the market would soon be empty. At the least, outsiders are loath to invest in securities markets where trading on inside information is prevalent.[127] As that is so, fairness[128] in relation to financial markets is more than an explanation for the regulation of certain wrongs. Fairness has an important role to play in the regulation of the financial markets[129] as it is a prerequisite for the continued existence of the market. It is a requirement for attracting investments from within a country's borders, but also for attracting international investments.[130] Indeed, it has been recognised that much

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[125] Cecchetti *Money, Banking and Financial Markets* 20.

[126] Ibid. 42.

[127] Asubel (1990) *Am Econ Rev* 1022. Asubel reformulated the rather broad and unspecific public confidence argument into an economic argument in support of the regulation of insider trading. In formulating his economic model, the author accepted that investor confidence in securities markets is the rational belief by outsiders that the return on their investments was not being diluted as a result of insiders trading.

[128] See I B Lee "Fairness and Insider Trading" (2002) 2002 *Colum Bus L Rev* 199; A Strudler & E W Orts "Moral Principle and the Law of Insider Trading" (1999) 78 *Tex L Rev* 375; D C Bayne "The Essence of the Insider's Duty" (1992–1993) 41 *U Kan L Rev* 315 and D A Winslow & S C Anderson "From 'Shoeless' Joe Jackson to Ivan Boesky: A Sporting Response to the Law and Economics Critique of the Regulation of Insider Trading" (1994) 81 *Kentucky Law Journal* 217.

[129] R A Schotland "Unsafe at any price: A reply to Manne, Insider Trading and the Stock Market" (1967) 53 *Va L Rev* 1438.

[130] Rider & French *The Regulation of Insider Trading* 6–7.

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of the difficulty in establishing capital markets in less developed countries arises from investors' distrust and their reluctance to invest funds in those markets.[131]

However, as Brand JA has observed with reference to the role of fairness in the law of contract, fairness, like beauty, often lies in the eye of the beholder.[132] As an abstract value it does not constitute an independent legal rule.[133] It cannot. For its content will always depend on the idiosyncrasies of the particular individual assessing what is fair in a specific situation.[134] Fairness thus merely informs the exercise of the rule-making[135] function of the legislature.

The Rhodian example shows that one cannot easily determine what fairness dictates a legal rule must be. While the Rhodian example and its market for wheat is distinguishable from insider trading and the market for securities, it does prove useful in giving content to the notion of fairness in a market setting. First, in trying to ascertain what the legal rule is in a situation comparable to that of insider trading, the Rhodian example shows that it is helpful to consider the rights of the participants in the market, much like Pufendorf and De Groot did in their analyses. Second, like Pufendorf, one asks whether there is something that binds the parties to the transaction. Pufendorf asked: is there an overarching agreement that requires the merchant (the party who knows more about the transaction) to conduct himself in a certain

[131] H Wu "An Economist looks at section 16 of the Securities Exchange Act 1934" (1968) 68 *Colum L Rev* 260 264. Also see the King Final Report 2 where it is stated that '[i]n the context of the Republic's re-integration into the financial markets and the Government's desire to create an environment conducive to foreign investment, there is therefore justified concern over the existing insider trading regulation in South Africa'. Although this point is especially noteworthy to a country like South Africa, it is most certainly not only true for developing markets. See S A Ramirez "Fear and Social Capitalism: The Law and Microeconomics of Investor Confidence" (2003) 42 *Washburn L Rev* 35 for the effect that corporate scandals such as Enron and WorldCom had on investor confidence in the United States.

[132] *South African Forestry Co Ltd v York Timbers Ltd* 2005 (3) SA 323 (SCA) par. 27. Also F D J Brand's "The Role of Good Faith, Equity and Fairness in the South African Law of Contract: The Influence of the Common Law and the Constitution" (2009) 126 *S African LJ* 71 and "The Role of Good Faith, Equity and Fairness in the South African Law of Contract: A further instalment" (2016) 2 *Stell LR* 238.

[133] Ibid.

[134] Ibid.

[135] Ibid.

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way? Third, like Pothier, one is to keep in mind the interests of the seller and, specifically, whether his profit could be seen as 'just'. In other words, is there any rationally acceptable explanation for the profit realised by the seller (or perhaps the good deal struck by a buyer), that a rule-maker should consider in formulating the rule?

These considerations, among others, will be used to determine a basis for the regulation of (or a theory of wrongfulness in respect of) insider trading in South Africa. Fairness, the considerations it gives rise to in the financial markets, and the confidence held in financial markets are not all equally reconcilable with the recognised bases for the regulation of insider trading. This is so as, at least, the oldest bases for regulation are not aimed at addressing a market wrong and fairness between traders in the market for securities *inter se*; they are rather concerned with enforcing the honouring of fiduciary duties and the protection of proprietary rights in information.

Compared to wrongful conduct in general, it is difficult to identify the precise harm insider trading causes.[136] It is for that reason that at least four theories of regulation exist. Each theory has its own explanation for the wrongfulness of insider trading. The theories could thus just as easily have been termed 'theories of wrongfulness'. Where the wrongfulness of insider trading lies, or what conduct is seen as wrongful in the context of insider trading, in turn determines who can be found to be guilty of insider trading or, at least, what is to be understood by 'inside information' and who can be found to be an insider. The four theories are: the fiduciary duty doctrine, the misappropriation theory, the parity of information theory, and the equal access to information theory. They can be divided into market and non-market theories.

[136] *Langevoort on insider trading* (Rel 7 4/2009) 14:3.

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2 2 Non-market related theories of regulation

2 2 1 The fiduciary duty doctrine

The fiduciary duty doctrine, as it has application to directors and officers of companies, only awkwardly manages to provide a basis for the regulation of trading on inside information. Among other things, the theory does not provide scope to cover all parties who have an unfair information advantage in securities trading. As it will be shown and explained, this uneasy fit is not limited to the fiduciary duty doctrine in the South African context. It is a problem that affects the development of the law in this area in the United States and other jurisdictions. It has given rise to a legacy of eschewed thinking; a legacy that has laudably been discarded in Australia at least in as far as that country's definition of 'insider' is concerned.

The doctrine is typically invoked to recognise a relationship of trust and loyalty between two persons requiring the one to act in accordance with the duties flowing from that relationship. Typically, fiduciary duties flow from relationships where one party (the fiduciary) acts on behalf of another party (the beneficiary). The fiduciary obtains a discretion to be exercised in relation to something of value belonging to the beneficiary. In essence, the imposition of the duty of loyalty or trust serves to protect beneficiaries from opportunistic self-serving behaviour by fiduciaries. In South Africa many of the founding principles of the fiduciary duty doctrine, as it has application to directors of a company, was formulated in *Robinson v Randfontein Estates GM Co Ltd*.[137] The principle that underlies directors' fiduciary duties are there said to be:

> Where one man stands to another in a position of confidence involving a duty to protect the interests of that other, he is not allowed to make a secret profit at the other's expense or place himself in a position where his interests conflict with his duty.[138]

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[137] *Robinson v Randfontein Estates GM Co Ltd* 1921 AD 168.
[138] Ibid. 177.

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We inherited this principle from Roman civil law, more specifically Digest 18.1.34.7.[139] Digest 18.1.34.7 provides '[a] tutor cannot buy a thing belonging to his ward; this rule extends to other persons with similar responsibilities, that is, curators, procurators, and those who conduct another's affairs'.[140]

According to Innes CJ, this principle must of necessity form part of every civilised system of jurisprudence.[141] He formulated the basis for the doctrine as it has application in our law near on a hundred years ago, but it has been accepted as still good law quite recently by the Supreme Court of Appeal.[142] What is clear from this founding principle, is the fact that the fiduciary duty of company directors is one that is aimed at precluding the director from competing with the company.[143] He, the director, is barred from acting in self-interest while not maintaining the company's best interests as his primary concern.

The duty is, however, owed only to the company. Directors conduct the company's, not each individual shareholder's, affairs.[144] As Solomon J said in *Robinson*: 'It is true that the board of directors is the agent of the company to manage its affairs and accordingly stands in a fiduciary relationship *to it*'.[145] (Emphasis added.) These sentiments were also accepted by Goldstone J in *Howard v Herrigal*[146] where it was said:

> At common law, once a person accepts an appointment as a director, he becomes a fiduciary *in relation to the company* and is obliged to display the utmost good faith *towards the company* and in its dealings on its behalf. (Emphasis added.)

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139 Ibid. 178. Also see *Aberdeen Railway Company v Blaikie Brothers* (1854) 1 Maqueen 474.
140 T Mommsen, P Krueger & A Watson *The Digest of Justinian* (1985) 60.
141 *Robinson v Randfontein Estates GM Co Ltd* 1921 AD 168 178.
142 See *Phillips v Fieldstone Africa (Pty) Ltd and Another* 2004 (3) SA 465 (SCA).
143 *Phillips v Fieldstone Africa (Pty) Ltd and Another* 2004 (3) SA 465 (SCA).
144 *Robinson v Randfontein Estates GM Co Ltd* 1921 AD 168 178–179.
145 Ibid. 216.
146 1991 (2) SA 660 (AD).

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And, when determining when his conduct is wrongful, 'regard must be had to the relationship *in which the director stood to the company*'.[147] He has a duty to safeguard and protect the affairs of the company.[148] Whereas the possibility of owing a co-shareholder a fiduciary duty was alluded to in *Bellairs v Hodnett*,[149] a director does not owe such a duty to a shareholder purely as a director.

That has been the rule since *Percival v Wright*.[150] When shareholders came to the English Chancery Division in 1902 to complain of directors who traded with information shareholders did not have access to, the court did not afford them a remedy. The judgment is authority for the proposition that directors of companies are neither trustees for, nor do they owe fiduciary duties to, individual shareholders.[151] It has also been taken to mean that directors with information not available to the shareholder, are allowed to purchase such shareholder's shares without any prior disclosure.[152] Directors could thus buy shares from shareholders without disclosing, for example, pending negotiations for the sale of the company, which would mean

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[147] *Robinson v Randfontein Estates GM Co Ltd* 1921 AD 168 178.

[148] *Howard v Herrigal* 1991 (2) SA 660 (AD) 674 D–E.

[149] *Bellairs v Hodnett* 1978 (1) SA 1109 (A).

[150] 1902 2 Ch 401 421.

[151] The court relied on *Walsham v Stainton* (1863) 1 De Gex, Jones & Smith 678, an 1863 case decided in the English High Court of Chancery. It dealt with a transaction where shares were bought by directors who conspired to obtain the shares of a shareholder at a price below the shares' value. The company's accounts were fraudulently kept and profits were stolen in what was, the court found, a 'fraudulent conspiracy' that made it possible for the directors to obtain the shares at a lower price. Knight Bruce LJ held that a '…relation of confidence as to property…' existed between the seller and the two officers. (689) Turner LJ held that '[a] more gross breach of duty, on the part of an agent towards his principal, cannot well be conceived…' (690) The case's applicability to modern insider trading is limited. It is distinguishable from the classic insider trading situation as it dealt with a situation where there was actual fraud committed by the buyer of the shares. (H L Wilgus "Purchases of shares of a corporation by a director from a shareholder" (1910) 8 *Michigan LR* 272.)

[152] Van Wyk De Vries 86 par. 4.51. Also see *Speight v Glass* 1961 1 SA 778 (D) 781; *Meskin v Anglo American Corp of SA* 1968 4 SA 793 (W). In Australia, Canada, and the United Kingdom *Percival v Wright* has been cited as authority for the fact that insider trading by a director does not, without more, breach any duty owed to a shareholder (S Herne "Inside Information: Definitions in Australia, Canada, the U.K., and the U.S." (1986) 8 *J Comp Bus & Cap Market L* 2.).

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an imminent increase in the price of the shares, and would have left the shareholders in a much better bargaining position had they known.

The facts of the case were as follows: it came to the attention of the plaintiffs that during their negotiations for the sale of their shares to the chairman of the board, the board was being approached by a person interested in acquiring the entire undertaking of the company. All the offers presented to the board represented prices per share, which were considerably more than the offer made by the plaintiffs to the directors. The negotiations for the sale of the whole of the company were unsuccessful and the transaction was never concluded. However, an action was instituted to set aside the sale of the shares to the directors. The shareholders argued that the directors ought to have informed the selling shareholders of the pending negotiations for the sale of the company.

Swinfin Eady J did not uphold these arguments, finding that, quite aside from any duties owed to shareholders, there is a duty on directors to dispose of the company's shares at the best price they are able to obtain.[153] The judge accepted that directors may not allot shares either to themselves or their friends at a lower price in order to secure a personal benefit. It was held, however, that while directors are to act in the best interests of the company, they do not stand in a fiduciary position towards individual shareholders. Purchasing directors had no obligation to disclose the negotiations and such a disclosure, being premature in nature, might even have been against the best interests of the company.[154] The fact that it was the shareholders who approached the directors to purchase the shares, and not the other way around, was emphasised. And the court attached significance to the fact that it was the shareholders that set the price at

[153] *Percival v Wright* (1902) 2 Ch 401 425.
[154] Ibid. 426.

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which the sale was to be made.[155] Accordingly, it was found that there was no 'unfair dealing' on the part of the directors.[156]

As a matter of interest, the 'unpalatable nature' of the *Percival v Wright* rule was soon recognised in England.[157] It was lamented by the Cohen Committee in 1945[158] and strongly rejected by the Jenkins Committee in 1962.[159] Soon, in a White Paper on company law reform,

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155 *Percival v Wright* (1902) 2 Ch 401 427. This is an important point and is still relevant today. The argument is that, at the time the transaction takes place, the seller is more than willing to accept the price offered and it is only after the transaction has been completed that the seller wants a better bargain, as he too becomes aware of the information previously known only to the buyer.

156 *Percival v Wright* (1902) 2 Ch 401 426.

157 Gower & Davies *Principles of Modern Company Law* 574.

158 See the United Kingdom's *Report of the Committee on Company Law Amendment presented by the President of the Board of Trade to Parliament by Command of His Majesty* June 1945 (Cohen Committee), where it is said that:

> Whenever directors buy or sell shares of the company of which they are directors, they must normally have more information than the other party to the transaction and it would be unreasonable to suggest that they were thereby barred from such transactions; but the position is different when they act not on their general knowledge but on a particular piece of information known to them and not at the time known to the general body of shareholders, e.g., the impending conclusion of a favourable contract or the intention of the board to recommend an increased dividend. In such a case it is clearly improper for a director to act on his inside knowledge, and the risk of his doing so is increased by the practice of registering shares in the names of nominees. None the less we do not recommend a prohibition on directors holding shares in the names of nominees. This is a useful convenience to the director and prohibition could be readily evaded, e.g., through the medium of a company controlled by the director. We do, however consider that the law should be altered so as to discourage improper transactions of the kind we have indicated. Even if the legislation is not entirely successful in suppressing improper transactions, a high standard of conduct should be maintained, and it should be generally realised that a speculative profit made as a result of special knowledge not available to the general body of shareholders in a company is improperly made. We would add that some directors who would not themselves take advantage of inside information do not so clearly appreciate the impropriety of letting it be known to their friends that events as yet unknown to the shareholders have made the shares of the company an attractive purchase.

159 See the United Kingdom's *Report of the Company Law Committee presented to Parliament by the President of the Board of Trade by Command of her Majesty* June 1962 (Jenkins Committee), where it is said that:

> We have recommended the inclusion in the Act of a general statement of the director's fiduciary duties to his company. But the case of *Percival v Wright* [1902] 2 Ch 401 421 provides authority for the proposition that no fiduciary duty is owed by a director to individual members of his company, but only to the company itself, and *a fortiori* that none is owed to a person who is not a member. The result is that a director who has by reason of his office acquired in confidence a particular piece of information materially affecting the value of the securities of his company (or any company in the same group) will incur no liability to the other party if he buys or sells such

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the wrongfulness inherent in insider trading started to be seen as distinct from that identified by the fiduciary principle.[160] It did, however, take some time before the United Kingdom implemented legislation comprehensively addressing trading on inside information.[161]

Until 1980, English insider trading law merely made it necessary to disclose directors' holdings and dealings in securities while also prohibiting the trading in put and call options by directors.[162] It was only in that year that insider trading was made an offence punishable by a

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> securities without disclosing that piece of information. *This seems to us to be wrong*. We have come to the conclusion that the law should protect a person – whether or not a member of the company or the companies concerned – who suffers loss because a director has taken unfair advantage at his expense of a particular piece of confidential information about the company or any other company in the same grouping any transaction relating to the securities in such companies. We realise that it might well be very difficult for the other party to establish that he was transacting with a director; this problem is particularly difficult in the case of transactions through the London Stock Exchange because of the method of settlement. It may also be difficult for the other party to establish a case. Nevertheless we think a remedy should be provided and we recommend accordingly below. (Emphasis added.)

Only some of the Jenkins Committee's recommendations were implemented. Directors' duties to disclose their dealings in their company's shares were expanded in the United Kingdom Companies Act of 1967, c 81.

[160] In the United Kingdom's *White Paper on Company Law Reform in England, Comnd.* (1973) 8:

> Unfair profits can on occasion be made in share dealings by the improper use of confidential, price-sensitive information that is not generally available to the investing public. This is prima facie most likely to happen in a bid, or expected bid situation, but in principle it can happen at any time. The efficient operation of the market as a source of capital, as a measure of industrial success and hence as a means of achieving a desirable and efficient disposition of resources, requires that relevant information should be fairly available, and that all investors should be able to back their knowledge and judgement rather than that favoured individuals should be able to take private advantage of confidential information. These requirements have so far been fulfilled by the application of the rules of the Stock Exchange and, in bid situations, by the Take-Over Panel. Without implying that malpractice has been widespread, the Government has concluded that it is necessary for the voluntary system to be reinforced by statue so as to ensure, as far as practically possible, that the market operates freely on the basis of equality between buyer and seller. Care must be of course taken to avoid unduly inhibiting the flexibility of the market. But the general desirability of ensuring equality of information to all potential or actual investors, and hence a proper disposition of the resources available to those investors, must have a high priority. The successful operation of the system demands a high degree of confidence in fair dealing on the Stock Exchange, and indeed in securities generally, whether or not publicly quoted.

[161] As a result of political ructions two Bills specifically aimed at prohibiting insider trading were never signed into law. These were the Companies Bill, 1973, and the Companies Bill, 1978.

[162] Gower & Davis *The Principles of Modern Company Law* 636.

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penalty or a prison sentence.[163] There were further enactments in 1980[164] and 1985.[165] Both evidenced strong fiduciary and misappropriation theory influence.[166] The European Community directive on Insider Trading in 1989,[167] however, necessitated a revision of the United Kingdom's insider trading rules.[168] This revision evidenced, it is said, a shift away from the fiduciary doctrine as the basis for the regulation of insider trading.[169]

The notion that directors do not owe fiduciary duties to shareholders individually has, however, not been left completely unchallenged by our courts. In *Sage Holdings v Unisec Group Ltd*[170] Goldstone J took issue with the principle laid down in *Percival*. He referred to and agreed with criticism of the decision. He further remarked that the rule, as it was formulated in the context of a face-to-face share sale contract, could not be applied without more to transactions done on the JSE. Those transactions should be distinguished, according to the court. And, it was remarked, that even if the directors were not guilty of a breach of fiduciary duty, one could

[163] Companies Act 1980, c 22.

[164] Companies Act 1980, c 22.

[165] Company Securities (Insider Dealing) Act 1985, c 8.

[166] A F Loke "From the fiduciary theory to information abuse: the changing fabric of insider trading law in the U.K., Australia and Singapore" (2006) 53 *Am Journal of Comp Law* 131 125; P L Davies "The European Community's Directive on Insider Dealing: From Company Law to Securities Market Regulation?" (1991) 11 *Oxford Journal of Legal Studies* 92.

[167] Council Directive 89/592/EEC of November 13, 1989, O.J. L334/30. This directive has been repealed by Directive 2003/6/EC of the European Parliament and of the Council of January 28, 2003 on insider trading and market manipulation (market abuse), art. 20, O.J.L 096 (effective date: April 12, 2003).

[168] Loke (2006) *Am J Corp L* 125. The United Kingdom Department of Trade and Industry produced a consultative document, *The Law on Insider Trading* (1989), which culminated in the Criminal Justice Act 1993, c 36.

[169] Loke (2006) *Am J Corp L* 125. Also see B A K Rider "The Control of Insider Trading – Smoke and Mirrors!" (2000) 19 *Dick J Int'L* 1. Rider's criticism against the approach was along the same lines as criticism levelled against the misappropriation theory generally. The criticism has it against the connection sought with the source of the inside information before the act of trading on the inside information is considered unlawful. Rider wrote: 'It would seem that the relationship must also be such that it is proper for the individual to have access to the information' before his trading could be found to be unlawful. In other words, a thief or a chance overhearer would not be prohibited from trading on the information.

[170] 1982 (1) SA 337 (W).

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call into question the directors' 'propriety and morality'. Criticism and moral judgements aside, however, *Sage* is not authority for the fact that *Percival* is not good law at common law.

What is accepted is that directors may place themselves in a fiduciary relationship to shareholders individually. This would be the case only where the directors act as agents specifically for those shareholders. The duty can thus arise from the circumstances of a specific case. The fiduciary doctrine therefore is not even properly adept at explaining the wrongfulness of insider trades between directors and individual shareholders.

More fundamentally, however, as it will be explained below, the fiduciary duty doctrine fails to explain properly the wrongfulness of the conduct of all traders trading with inside information. Its historic part in the formulation of prohibitions on insider trading did, nevertheless, have a great effect on the legal development in this branch of the law. The wrong of insider trading was going to be one seen, at least when legislatures the world over started to intervene, as perpetrated by directors against their shareholders, instead of being seen as one perpetrated by share traders *inter se* trading in the financial markets.

The large role the fiduciary duty doctrine plays in insider trading regulation[171] is, in my submission, a remnant of outdated thinking on the subject. It is largely a result of the United States federal securities regulation's development, which has been at the forefront in developing the bases for the regulation of insider trading.[172] It is especially the broad anti-fraud section, found in the Securities Act, that has allowed the courts to have free reign in

[171] See, for instance, Loke (2006) *Am J Corp L* 131 who writes that the fact that insider trading in the United States turns on fiduciary duty is 'only because of how the case law built upon an open-textured anti-fraud rule'.

[172] See Loke (2006) *Am J Corp L* 123 on the historical development in United States law. The author argues that 'with its market capitalization and regulatory sophistication, U.S. federal securities laws continues to lead internationally in forging the norms of securities regulation'.

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'developing' the law in this field.[173] These developments have spilled over to other common law jurisdictions and have been considered by legislatures in drafting their respective country's legislation. Starting from a broad anti-fraud provision and initial fiduciary thinking on insider trading, the United States insider trading law development had an ill-founded starting point.[174]

Prior to 1940, the majority of United States courts, especially the courts of what was at that time recognised as the financial and industrial states, also held, in line with the established common law, that specifically officers or directors of corporations did not owe fiduciary duties to individual shareholders. Consequently, the mere fact that a director or officer of a company had not disclosed inside information to a seller shareholder, did not found an action. A director or officer was free of any liability as long as he did not mislead, or perpetrate a fraud upon, a selling shareholder.[175]

The general view was that directors and officers of a corporation were free to deal with their shares as any other shareholders in the market. They did not owe any additional duties to their

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[173] Of Rule 10b-5, and the private rights of action to which it gives rise, the following was said by Rehnquist CJ in *Blue Chip Stamps v Manor Drug Stores*, 421 US 723 (1975): 'When we deal with private rights of actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.' Loke (2006) *Am J Corp L* 126 writes as follows about Rule 10b-5: 'As the legislative basis for the development of the rule against insider trading, the case law that it has spawned has been nothing less than remarkable.' This is, of course, not necessarily a positive state of affairs.

[174] S M Bainbridge "Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud" (1999) 52 *SMU L Rev* 1589; Langevoort (1999) *Colum L Rev* 1319; D C Langevoort "Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future" (1995) 20 *Del J Corp L* 865; J R Macey "From Fairness to Contract: The New Direction of the Rules on Insider Trading Regulation" (1984) 13 *Hofstra Law Review* 13–29; J Seligman "The Reformulation of Federal Securities Law Concerning Nonpublic Information" (1985) 73 *Geo LJ* 1083; J E Fisch "Start Making Sense: An Analysis and Proposal for Insider Trading Regulation" (1992) 26 *Ga L Rev* 179; D C Langevoort "Book Review – The Education of a Securities Lawyer (1985) 80 *Nw U L Rev* 261–262.

[175] See K L Yourd "Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities and Exchange Act" (1939) 2 *Michigan Law Review* 139. Also see the leading authoritative cases at that time: *Carpenter v Danforth* 52 Barb (NY) 581 (1868); and *Board of Commissioners of Tippecanoe County v Reynolds* 44 Ind 509 (1873).

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counterparts in the securities markets. The principle is said[176] to have emanated from an 1847 United States case where it was held that:

> There is no legal privity, relation, or immediate connection between the holders of shares in a bank, in their individual capacity on the one side, and the directors of the bank on the other. The directors are not the bailees, factors, agents, or trustees of such individual stockholders.[177]

However, the odd judgment holding that directors and officers of a company owed a fiduciary duty to individual shareholders did emerge. According to these judgments, directors and officers were prevented from trading at arm's length in the market if they did not make a full disclosure of all the relevant facts pertaining to the value of the shares being sold. In a 1903 case, *Oliver v Oliver*,[178] it was held that:

> It is a matter of common knowledge that the market value of shares rises and falls, not only because of an increase and decrease in tangible property, but also by reason of real and contemplated action on the part of managing officers; declaring or passing dividends; the making of fortunate and unfortunate contracts; the loss or gain of property in disputed profitable or disadvantageous sales or leases. And to say that a director who has been placed where he himself may raise or depress the value of the stock, or in a position where he first knows of facts that may produce that result, may take advantage thereof, or buy from or sell to one whom he is directly representing, without making a full disclosure and putting the stockholder on an equality of

[176] H L Wilgus "Purchase of shares of corporation by a director from a shareholder" (1909–1910) 8 *Mich L Rev* 267.

[177] *Smith v Hurd* 53 Mass. 371 (1847).

[178] The leading case at that time holding this viewpoint was said to be *Oliver v Oliver* 45 SE 232 (1903). (See Yourd (1939) *Michigan Law Review* 141). In Oliver it was held that the fact that a director owes a fiduciary duty to the corporation that employs him and its body of shareholders, should not be perverted to mean that he is not under a duty to each. Furthermore, the court held that the fact that a director must serve the corporation does not warrant him becoming an active opponent of the individual shareholder, especially if one considers the latter's undivided interest in the property committed to the director's care. At the time, the approach in the Oliver case was championed by United States legal scholars. See A A Berle "Publicity of Accounts and Director's Purchases of Stock" (1927) 25 *Mich L Rev* 827; A H Bigelow "The Relation of Directors of a Corporation to Individual Shareholders" (1915) 81 *Cent L J* 256; N C Collier "Liabilities of Directors and of Trustees of Beneficial Owners Compared" (1912) 74 *Cent L J* 74; C D Laylin "The Duty of a Director Purchasing Shares of Stock" (1918) 27 *Yale L J* 27; H R Smith "Purchase of Shares of Corporation by a Director from a Shareholder" (1921) 19 *Mich L Rev* 698; W W Thornton "The Trust Relation between Corporate Officers and Stockholders buying of, or selling their stock to them" (1908) 67 *Cent LJ* 67; and H L Wilgus "Purchase of Shares of a Director from a Shareholder" (1910) 8 *Mich L Rev* 267.

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> knowledge as to these facts, would offer a premium for faithless silence, and give reward for the suppression of the truth.

Expositions such as those in *Oliver* were recognised by American scholars at that time as being evidence of an increasing social consciousness about the transactions of the corporate world.[179] The general rule, that directors were free to trade, was seen at the time as the epitome of laissez-faire doctrine of free and unrestricted trading under all circumstances.[180] Notwithstanding opposition to it, the general rule stood, but not without losing some ground. The 'special facts doctrine' developed.

The special facts doctrine is still good law in some states.[181] The *locus classicus* of the special facts doctrine is the United States Supreme Court judgment of *Strong v Repide*.[182] The doctrine applies to shareholders selling shares in face-to-face transactions to directors of the issuer company.[183] The facts were as follows: Repide was the owner of more than two-thirds of the shares in the Sugar Estates Development Company, was one of five directors, and had been elected by the board as the agent and administrator general of the company. The company owned a large part of the Philippine friar lands. Repide was representing the board in negotiations for the sale of those lands to the United States government. The plaintiff in the case, Mrs Strong, owned only a few shares in the company. She placed her shares in the possession of her agent, Jones. She gave Jones the power to sell the shares at a specified price.

While Repide was negotiating with the United States government, holding out for a higher price for the company's lands, he began taking steps to purchase Mrs Strong's shares. Jones

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179 See Yourd (1939) *Michigan Law Review* 142.

180 Ibid. 143.

181 See Loke (2006) *Am J Corp L* 127 note 9. Also see *Treadway Companies Inc. v. Care Corp*. 638 F. 2d 357 (2d Cir 1980).

182 213 U.S. 419 (1909).

183 See for instance *Kardon v. National Gypsum Co*. 73 F. Supp 798 (E.D. Pa. 1947) and *Kohler v. Kohler Co.* 319 F.2d 634 (7th Cir. 1963).

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occupied an office right next door to Repide. Instead of going to see Jones, however, Repide employed one of his relatives, who in turn employed a broker with an office some distance away, to purchase the shares from Jones. The relative instructed the broker that the shares were for a family member. On the facts, Jones never became aware of the true purchaser's identity and it was common cause that, if he had become so aware, he would not have sold the shares at the price he did. It was further common cause that no facts relating to the state of the negotiations with the United States government had been brought to the agent's attention.

The trial court found that Repide concealed from Strong's agent 'facts affecting the value of the stock which he in good faith was bound to reveal'. Repide was ordered to return the shares to Strong. The Philippine Supreme Court, however, reversed the decision, holding that absent a positive act of fraud that includes either false promises or an abuse of confidence, the sale was good. The Supreme Court of the United States, in turn, overturned the Philippine court. It held as follows:

> If it were conceded, for the purpose of argument, that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of the director to disclose to the shareholder the general knowledge which he may possess regarding the value of shares of the company before he purchases any from a shareholder, yet there are cases where, by reason of the special facts, such duty does exist.[184]

The court listed eight special facts that, in the case before it, caused a duty to be recognised: the defendant was a director; he owned three-quarters of the company's stock; he was the administrator general of the company and had extensive powers; he was engaged in negotiations that finally led to the sale of the land at a price that greatly enhanced the value of the stock; he was the chief negotiator in that transaction; he was acting substantially as the agent for the shareholders by reason of his ownership of shares and by acquiescence of the other shareholders; the negotiations were for the sale of the whole of the property; and the lands were the only valuable asset of the company. To prove these special facts was an onerous

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[184] 213 US 419 (1909) 431.

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onus to bear. Furthermore, the anonymous nature of stock market transactions rendered the application of the special facts doctrine, at best, problematic. The suggestion that a director owed a duty to disclose inside information in stock exchange transactions was therefore rejected.[185]

After the United States stock market crash of 1929, the Securities and Exchange Act of 1934 was enacted. The 1934 report of the United States Senate Banking and Currency Committee stated:

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their position of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.[186]

The main provisions on insider trading in the United States were enacted in section 10(b) of the Securities and Exchange Act.[187] Section 10(b) is a broad anti-'fraud'[188] provision. It must also be noted that Congress has intervened on numerous further occasions[189] and the SEC has

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185 *Goodwin v Agasiz* 186 NE 659 (Mass 1933).

186 As cited by W R McLucas, J H Walsh & L L Fountain "Settlement of Insider Trading Cases" (1992 – 1993) 48 *Bus Law* 69 80 note 3.

187 Section 10(b) of the Securities and Exchange Act, 1934 (United States).

188 The section addresses a broader range of misconduct than what is normally recognised as 'fraud'.

189 Congressional Reaction of 1984: Insider Trading Sanctions Act of 1984. See in this regard T W Joo "Legislation and Legitimation: Congress and Insider Trading in the 1980s" (2007) 82 *Ind LJ* 575. For an expression of doubt that the 1984 legislation had the desired deterrent effect see H N Seyhun "The Effectiveness of the Insider Trading Sanctions" (1992) 35 *J L & Econ* 149 and S Thel "Statutory Findings and Insider Trading Regulation" (1997) 50 *Vand L Rev* 1091. See further the Sarbanes Oxley of 2002. Its section 304 requires the company's chief executive officer and chief financial officer to forfeit any profits made from the purchase or sale of stock during a twelve-month period if the company restates its financial reports. Section 306 prohibits directors and executive officers from trading in shares in a 'blackout period' during which lower level employees are barred from trading in their company managed retirement or employee stock option plans (ESOP accounts). Section 403 amends section 16 of the Securities and Exchange Act to accelerate the deadline for the reporting of insider trading by officers, directors and large shareholders.

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promulgated regulations in terms of the Securities and Exchange Act.[190] Section 10(b) is supplemented by Rule 10b-5. Section 10(b) provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 reads:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as fraud or deceit upon any person, in connection with the purchase or sale of any security.

Insider trading is not referred to expressly in either section 10(b) or Rule 10b-5. In addition, both the section and the Rule's prohibition, on a plain reading, is aimed at 'any person'. It may therefore come as a surprise that a great part of United States jurisprudence on insider trading has focused on identifying who may be found guilty of insider trading. The insistence furthermore on bringing insider trading regulation within the scope of the fiduciary duty doctrine has left the United States law, at best, complex.[191] Doctrinal refinement and coherence

[190] See Regulation FD or "Regulation Fair Disclosure." It addresses the problem of selective disclosure by companies and their senior executives.

[191] H Kripke "Note on insider trading: an example of how not to make a law" (1987) 39 *Ala L Rev* 349 349 refers to the 'mess [Americans] call insider trading law' and L Loss "History of SEC Legislative

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have given way to reactionary jurisprudential ingenuity to stretch the ambit of the restrictions on insider trading.[192] The fiduciary doctrine also made its way into South African insider trading law, as it has done in many other branches of the law. Most notably, it is recognised by the inclusion of 'directors' a specific type of insider in the definition of 'insiders'.

The fiduciary duty doctrine provides only a basis for the regulation of insider trading by directors and others who owe fiduciary duties. If the doctrine is strictly employed, only they would be held liable for insider trading. What is more, they would be held so liable only in instances where they are dealing with shareholders, and not with prospective shareholders. In other words, directors and officers could be held liable only where they buy shares from incumbent shareholders as they owe a duty only to those already holding equity in their company. When the directors sell shares, they are contracting with independent third parties who, at the time of the sale, are not owed any fiduciary duty, if those third parties do not yet own equity in the director's company. For a legal system thus to base its insider trading regulations on the fiduciary duty doctrine, it must implicitly recognise that the directors and officers owe fiduciary duties not only to incumbent equity holders, but also to prospective holders of equity: an untenable position.

The doctrine also fails to explain the prohibitions on trading on inside information in securities other than equities. The South African legislature has, for instance, since the enactment of the Insider Trading Act, made it clear that as far as trading on inside information is concerned, what is good for equity is good for debt securities and derivatives. The King Task Group concluded that it was not clear from the definition of the then section 440A(1) of the

Programs and Suggestions for a Code" (1967) 22 *Bus Law* 795 796 asks, 'How big a house of cards can we continue to build on rule 10b-5?'. Also see D C Langevoort "Setting the agenda for legislative reform: some fallacies, anomalies, and other curiosities in the prevailing law on insider trading" (1987) 39 *Ala L Rev* 399.

[192] *Langevoort on insider trading* (Rel 5 4/2007) 2-2.

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Companies Act[193] whether financial instruments had had to be issued by a company for the insider trading provisions to apply.[194] If it did not, only trading in derivatives issued by the company would have been included in the prohibition of insider trading.[195] They advised that trading on inside information in 'traded options and indices which are not "issued" by a company' had to constitute an offence.[196] They further advised unequivocally that the South African regulation of insider trading should regulate all markets, including the equity, derivative and bond markets.[197] In view of the anonymity that characterises transactions on regulated markets as opposed to the over-the-counter market, trading on inside information in 'all securities and financial investments' listed on a regulated market, whether they were issued by a company or not, should, according to the Commission, be regulated.[198] They thus proposed a broad inclusive definition of 'financial instrument', which has been retained in the Act.[199] It is a central provision in determining the ambit of the Act and the offences it creates.

This expansive definition of 'securities' has resulted in an approach at odds with what was an accepted truth at the end of the previous century: that insider trading was a wrong perpetrated only in equity securities. The Act's definition includes derivative and debt securities. The only way the definition is circumscribed in the market abuse section, is by way of its definition of 'insider' and 'inside information'. The definitions limit the provisions' application to

[193] The 1973 Companies Act.
[194] King Final Report 10.
[195] Ibid.
[196] Ibid.
[197] Ibid.
[198] Ibid. 11.
[199] It defined 'financial instrument' as meaning a 'financial instrument as defined in section 1 of the Financial Markets Control Act, 1989 (Act 55 of 1989), and any instrument or right bearing substantially similar characteristics to any such financial instrument and which is dealt with on a regulated market'. The Financial Markets Control Act defined 'financial instrument' as '(a) a futures contract; (b) an options contract; (c) loan stock; (d) or any other instrument declared by the Registrar by notice in the Government Gazette to be a financial instrument'.

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securities listed on a regulated market.[200] It is clear, however, that the prohibitions deal not only with trades in equity but also in debt instruments and derivatives.

It seems to follow quite naturally that if a person is not allowed to trade with inside information in equities, he must not be allowed to trade with inside information in debt instruments and derivatives.[201] It is, however, not so simple if the basis for the regulation of trading on inside information is the fiduciary doctrine. The question to be answered for the purposes of determining whether the fiduciary duty doctrine could provide a basis for the regulation or prohibition of insider trading in derivatives is: where would one find the fiduciary link between a trader accused of trading with inside information and the company (if the derivative relates to a company at all) of the security being traded? For the requirement of some fiduciary duty being owed to a counterparty before an insider can be held liable for insider trading, would rarely be fulfilled outside the equity market.[202]

To understand the rights and obligations at play in the derivatives market and why requiring a fiduciary link in the regulation of insider trading in these instruments is nonsensical, it is first necessary to ask what a derivative is. The Act defines 'derivative instrument' as meaning any '(a) financial instrument; (b) or contract, that creates rights and obligations and whose value depends on or is derived from the value of one or more underlying asset, rate or index, or measure of economic value or on a default event'.[203] Derivatives are thus financial instruments with certain specified characteristics. As the name and the Act's definition suggest, they derive their value from the values of other underlying securities or other variables. Those variables

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[200] A 'regulated market' is in turn defined to mean 'any market, whether domestic or foreign, which is regulated in terms of the laws of the country in which the market conducts business as a market for dealing in securities listed on that market'.

[201] In New Zealand, for instance, certain conduct by traders in futures contracts, and their advisors, are not regarded as contraventions of their insider trading preventions. See the New Zealand Securities Markets (Insider Trading Exemption – Futures Contracts) Regulations 2010.

[202] H L Pitt & K A Groskaufmanis "A tale of two instruments" (1993–1994) 49 *Business Lawyer* 188.

[203] Section 1.

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include an index, a reference interest rate, an equity instrument, a bond or even another derivative. A significant amount of derivatives trading happens on the JSE.[204] Exchanges, not companies, are free to create virtually any derivatives contract they please. The only restraint on their power is demand. Demand is in turn determined by, among other things, the envisioned instrument's standardisation, market depth and liquidity.

To illustrate the inherent difficulties the fiduciary doctrine has in providing a regulatory basis, it will suffice to discuss options as examples of derivatives. What is known as an option contract on regulated exchanges is an agreement of sale having as the merx a right to buy or sell a specific quantity of an underlying asset (whether it be equity, an interest-bearing security, currency or commodity) or other derivatives (whether it be futures, swaps or other options) at a specified price at or before a date in the future. In accordance with its classification as a derivative, the merx is not, for example, the commodity itself, but the right to buy the commodity.

Economists, in assessing options, focus on the option's 'intrinsic value'. The option is viewed relative to the underlying asset or derivative to which it relates. Most important in this assessment, is the price at which the underlying asset or instrument can be bought by the holder of the option: the strike price. The strike price will remain constant, but the price of the underlying commodity is bound to fluctuate.[205] A price increase in the commodity will therefore result in an increase of the intrinsic value of the option as it now confers the right to buy something cheaper relative to market value. Of course, option agreements confer not only rights to buy, but also rights to sell.[206] A call option gives the buyer the right to buy (or call) a specified number of shares of a specific company from the option writer at a determined

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[204] 161,1 million derivative contracts were traded on the JSE in 2010. (Goodspeed "The Derivatives market" in K Van Wyk, Z Botha & I Goodspeed *Understanding South African Financial Markets* 4 ed (2012) 387–415.

[205] Pitt & Groskaufmanis (1993–1994) *Business Lawyer* 192.

[206] Ibid.

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purchase price at any time up to and including the strike date. A put option is the converse. It grants the buyer the right to sell (or put) a set number of a particular company's shares at a set selling price at any time up to and including the strike date.[207]

In all this the following is clear: neither the issuer nor its insiders necessarily play any role in the conclusion of an options agreement. There is generally no fiduciary duty owed by an issuer's insiders and an option holder. Options are not even issued by the company, but by an option clearing corporation or exchange. By purchasing an option, the purchaser does not gain an equity stake in the company, but merely the right to purchase or sell equity at a later stage.[208] In other words, options holders do not have equity, they merely have a right to buy or sell equity. The fiduciary duty doctrine fails to explain the prohibition on trading on insider trading in options.

These difficulties are well illustrated by the United States' case of *Laventhal v General Dynamics Corporation*.[209] The case concerned an action by the owner of options to buy shares in General Dynamics. Leventhal filed a class action on behalf of all persons who sold options or other securities during a specified period. He based his action on the allegation that General Dynamics traded on inside information during that period. However, were call option holders competent to bring an action under an insider trading provision based on the fiduciary doctrine?

Laventhal argued that the corporation's trading in its own shares on inside information, caused him, an options holder, damage. The court found, though, that there was no action for insider trading. It reasoned that the options held by Laventhal were issued by an options clearing corporation. The securities traded were call options, or options to purchase, and that these are

[207] Ibid.
[208] Ibid. 197.
[209] *Laventhal v General Dynamics Corporation* 704 F.2d 407 (1983) 412.

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contracts with a private brokerage firm to purchase shares, or any other security, of a specified company in the future at a specified price.[210] It reasoned that options, as opposed to equity, are bought because they offer an investor the possibility of a high return for a minimal investment and that they are more speculative in nature. Even though the target shares' share price may increase, the option could expire worthless. If the option is not exercised or it is not sold prior to its expiration, the option holder stands to lose his entire investment: the option purchase price.[211] Accordingly, held the court, options trading can be seen as inherently risky, that investors voluntarily accept that risk by entering into the options market, and this means (as it was previously held by United States courts) that they do not to afford their holders the same fiduciary duty protection as traders in the share market.[212]

The distinction between options and equity does not end there. The relationship between the directors and officers of a company and its shareholders is wholly different from that between directors and officers and options holders. Both shareholders and options holders rely on the general welfare of the company to a certain extent. This much is true. Options holders, however, unlike shareholders, do not hold equity in the company prior to exercising the option.[213] Therefore they have no rights such as those of the shareholder, to bring an action against a director or officer of the company under the fiduciary duty doctrine, born out of holding equity in the company. A fiduciary duty arises only once an options holder becomes a shareholder.[214]

What further complicates the application of the fiduciary doctrine is the fact that where options are involved, trading happens in more than one market.[215] When equity is purchased using

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[210] Ibid. 410.
[211] Ibid.
[212] See Pitt & Groskaufmanis (1993–1994) *Business Lawyer* 202.
[213] *O'Connor & Associates v Dean Witter Reynolds Inc* 529 F Supp 1179 (SDNY 1981) 1184–1185.
[214] Ibid. 1185.
[215] See *Laventhal v General Dynamics Corporation* 704 F.2d 407 (1983) 413.

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inside information, damage could be caused to an options holder. The shares are purchased in the share market, whereas the options holder trades in the options market. The trade can be seen as too far removed from the loss by the options trader to prove a causal connection between the impugned conduct and the loss.[216]

It can also be argued that options trading, and option traders, are at a certain level not that different from share traders, and shareholders. That they too should enjoy fiduciary, or at least misappropriation, protection. And that there is indeed such protection. Those that take up this position argue idealistically, without reference to principle, that options reduce volatility and heightens the liquidity of equity markets, allowing shareholders the opportunity to hedge the risk inherent in their equity investment by shifting it to options holders.[217] Trading in options are therefore not to be seen as gambling, but rather as risk allocation.[218] The distribution of risk enhances the liquidity of the market for a company's shares and, therefore, lowers the cost of capital to the company.[219] The fiduciary duty as owed to shareholders, should therefore be extended to options holders as they also bear risk.[220] It is further argued that options investors share many of shareholders' expectations.[221] They too rely on the integrity of the directors and officers of the company to whom their options relate.[222] What is more, even though the initial purchase of an option, unlike the initial public offering of equity, does not result in an influx of capital to the company, the secondary markets for the two instruments have the same effect on the company's coffers. The trading of both instruments in the secondary market merely

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216 Ibid.

217 *Moskowitz v Lopp* 128 FRD 624 (ED Pa 1989) 633.

218 Pitt & Groskaufmanis (1993–1994) *Business Lawyer* 208. Also see E M Sacksteder "Securities Regulation for a Changing Market: Option Trader Standing under Rule 10b-5" (1998) 97 *Yale L J* 32 – 633 where it is said: 'The options market thus enhances the depth and liquidity of the stock market, maximizing stock prices and lowering the corporations cost of capital'.

219 Pitt & Groskaufmanis (1993–1994) *Business Lawyer* 208. Also see *Tolan v Computervision Corp* 696 F Supp 771 (D Mass 1988) where it is said: 'Studies have shown that options trading may decrease the price volatility of the underlying securities on which the options are written, and also that the presence of options may increase trading volume of the underlying security, thereby increasing stock liquidity'.

220 *Moskowitz v Lopp* 128 FRD 624 (ED Pa 1989) 633.

221 Pitt & Groskaufmanis (1993–1994) *Business Lawyer* 206.

222 Ibid. 207.

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serves to maintain the liquidity of the market for the company's shares.[223] This might all be true. Considerations of equity, however, cannot give rise to a duty without more.

The question whether options traders should be protected against insider trading, has been dealt with in South Africa. The legislature has said yes. What should now be clear is that the fiduciary doctrine faces at best considerable difficulties in providing a rationale for that protection. At worst, it simply doesn't.

The fiduciary doctrine similarly fails to explain the prohibition of trading on inside information in bonds. A bond in this context is a right to the repayment of a loan and interest. A share, or equity stake, in a company, on the other hand, involves more than a claim for the repayment of a loan. South Africa has had an active bond market since the mid 1970s. The volumes and values of trades in this instrument increased dramatically in the 1980s through the 1990s.[224]

Traditionally corporate bonds were viewed as an extremely safe investment. It was believed that there was a less pressing need in the bond market to keep the same close eye on bond issuers than was kept on companies whose equity one holds. So the market for suitably rated bonds also became a haven for institutional investors.[225] Especially in large markets, such as that of the United States, a change has occurred, which makes bond markets more susceptible to insider traders. Especially the development of high yield bonds (or junk bonds) has caused the traditionally held view of bond markets, that they hold the promise of a low risk steady investment, to change for the worse.

223 Ibid. 208.

224 F Viljoen "Settlement of Transactions on the South African Bond Exchange" (1998) 10 *SA Merc LJ* 1 2. Also see this article for a general history and an overview of bond trading in South Africa.

225 Pitt & Groskaufmanis (1993–1994) *Business Lawyer* 214.

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Basing the regulation of insider trading in bonds on the fiduciary doctrine flies in the face of the traditional perceptions of creditors' rights.[226] Traditionally, shareholders are seen as the corporation's owners, whereas debt holders, like bond holders, are the company's creditors.[227] It is a long-accepted rule that directors do not stand in a fiduciary relationship to their company's creditors.[228] Pitt & Grauskafmanis present a neat distinction between bonds and equity:

> The stockholders are the corporation's owners; the debt holders are its creditors. Corporate law is for stockholders; contract law is for debt holders.' Corporate directors are charged with protecting stockholder interests; the indenture represents the debt holders' protection.[229]

A corollary to this traditional view is that corporate officers do not owe fiduciary duties to corporate bondholders; the two groups are tied to each other only by way of a bond contract.

There are two schools of thought about the role played by the bond contract in the relationship between fiduciaries and bondholders. The one school argues that bondholders should not to be afforded fiduciary protection as they are able to protect themselves through the bond agreement. They can negotiate for all the protection they desire.[230] The other school argues that this is a fiction. The bond contract's terms, it is said, is determined by three principal actors: the corporation, the underwriters, and the bond trustee.[231] The bondholder does not have the opportunity to negotiate anything because, quite simply, at the point of negotiation

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226 Ibid. 220.

227 M W McDaniel "Bondholders and Corporate Governance" (1986) 41 *Bus Law* 413.

228 M S Blackman, R D Jooste, G K Everingham, M Larkin, C H Rademeyer & J L Yeats *Commentary on the Companies Act* (Revision Service 8 2011) 8–51. The following English cases are cited as authority for this proposition: *Re Whincham Ship building, Boiler, and Salt Co (Poole, Jackson, and Whyte's case)* 1878 9 Chd 322 328–329 (CA); *Re Forest of Dean Coal Mining Co* (1978) 10 Chd 450 453; *Wilson v Lord Barry* (1880) 5 QBD 518 (CA); and *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187 217–219; *Spies v R* (2000) 35 ACSR 500 526 (HC of A).

229 Pitt & Groskaufmanis (1993–1994) *Business Lawyer* 220 quoting from McDaniel (1986) *Bus Law* 413.

230 Pitt & Groskaufmanis (1993–1994) *Business Lawyer* 223.

231 L E Mitchell "The Fairness Rights of Corporate Bondholders" (1990) 65 *NYUL Rev* 1165 1179.

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the bondholder is not in the picture yet. He acquires the security, like the purchasers of equity, only on the market. Bondholders therefore require the protections of the fiduciary doctrine.

I do not agree. The bondholder has a contract with the company according to the debt he has accorded it. When he sells the rights and obligations under that contract in the market, the buyer buys those rights and obligations. The situation is wholly different from the one where a shareholder purchases shares and knows that he is getting equity and will be treated in accordance with the company's founding documents. Bondholders are not owed fiduciary duties and therefore the fiduciary duty doctrine fails to explain the wrongfulness of insider trading in bonds.[232]

The fiduciary duty doctrine as applicable to directors trading on inside information, is not a suitable basis for the regulation of insider trading, a financial market wrong. It not only fails to explain the wrongfulness of insider trading where a director trades on the strength of inside information with a single incumbent shareholder, it also fails to explain the wrongfulness of directors trading with purchasing or prospective shareholders and insider trading generally in bonds and derivatives. Indeed, Loke writes that '[i]f one were to start on a clean slate, it is doubtful whether one would adopt the fiduciary theory as the basis for constructing insider trading liability'.[233] The South African legislature has had ample opportunity to excise the remnants of the fiduciary doctrine from the regulation of insider trading. It has regrettably failed to do so.

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[232] See in general Note "Insider Trading in junk bonds" (1992) 105 *Harv L Rev* 1720; R R Pengra "Insider Trading, Debt Securities, and Rule 10b-5: Evaluating the Fiduciary Relationship" (1992) 67 *NYUL Rev* 1354.

[233] Loke (2006) *Am J Corp L* 131.

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2 2 2 The misappropriation theory

According to the misappropriation[234] theory it is wrongful for persons to trade in securities on the strength of inside information they obtained in the course of the performance of their corporate duties.[235] It founds the wrongfulness of insider trading where information meant for a corporate purpose is received and employed to another end.[236] The theory views inside information as the property of the corporation for whom the corporate duties are performed (which is not necessarily the relevant issuer). The wrong perpetrated by the misappropriator is perpetrated against the person or entity who entrusted him with the information, the source of the information, and not the person with whom he trades.[237] In other words, the wrongfulness is not found in the simple fact that one trader has an unconquerable information advantage over his counterparty; it is rather found in the fact that the one trader has an information advantage over the other by virtue of 'an abuse of position, a violation of trust, or a betrayal of confidence' owed to the source of the information.[238]

The theory originated in the United States Second Circuit. It was judicially conceived, firstly, as a result of the failings of the fiduciary doctrine to cover certain forms of insider trading, which were also perceived as worthy of prohibition and,[239] secondly, as a result of the United

234 According to the *Oxford Dictionary of English* (C Soanes & A Stevenson *Oxford Dictionary of English* 2 ed (2005)) to 'misappropriate' is to 'dishonestly or unfairly take (something) for a wrong purpose or in a wrong way'.

235 *Langevoort on insider trading* (Rel 6 4/2008) 1–22 and B B Aldave "Misappropriation: A General Theory of Liability for Trading on Nonpublic Information" (1984) 13 *Hofsta Law Review* 114. The United States Supreme Court has described the breach as being found in 'feigning fidelity to the source of the information without disclosure to the source'. *United States v O'Hagan* 117 S Ct 2199 (1997) 2207.

236 *Langevoort on insider trading* (6/2004) 6-4. Also see *United States v Newman* 664 F 2d 12 (1981), one of the first cases prosecuted in the United States under the misappropriation theory.

237 See *Langevoort on insider trading* (Rel 7 4/2009) 6-1.

238 Aldave (1984) *Hofstra Law Review* 121.

239 *Langevoort on insider trading* (6/2004) 6-3. Also see M P Kenny & T D Thebaut "Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)" (1995) 59 *Alb L Rev* 139. The United States Supreme Court has held that the fiduciary theory and the

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States Supreme Court's reluctance in accepting the equal access to information theory as the basis for their insider trading prohibition.

It is especially in the mid to late 1970s with the merger and acquisitions explosion in the United States that the SEC and the United States Department of Justice began looking for novel ways to stretch the broad anti-fraud provision on their statute book to capture parties in corporate deals who did not fit the traditional idea of a fiduciary insider.[240] If a prohibition based on the misappropriation theory is available to a court, together with a prohibition based on the fiduciary duty doctrine, the misappropriation theory enlarges the scope of a prohibition on insider trading to include at least some of those traders who would traditionally not have been viewed as insiders. The misappropriation theory covers people who do not owe any fiduciary duty to the company or its shareholders, but who possess inside information. This theory of wrongfulness therefore provides for a limited extension for holding those liable for insider trading who do not owe duties to the issuer company.

misappropriation theory are complementary. The classical theory focuses on a corporate insider's breach of duty to shareholders with whom the insider transacts. The misappropriation theory focuses on the trading on non-public confidential information by a corporate outsider in breach of a duty to the source of the information. The misappropriation theory thus extends the protection of securities markets in that it also restricts trading on non-public information by persons who do not owe a duty to the company's shareholders. (*United States v O'Hagan* 117 S Ct 2199 (1997) 2208).

[240] Brodsky (1998) *Cardozo L Rev* 42. In a legislative history provided with the enactment of the Insider Trading Sanctions Act of 1984, Pub L No 98-376, 98 Stat. 1264 (codified at 15 U.S.C. section 78 (1988) the United States Congress stated that:

> Insider trading has become a more widespread problem in recent years, with the increase in mergers and tender offers, which often result in immediate and dramatic price movements in the stock of a target company, and with the growth of the options market, where a small investment in options can yield enormous profits if the underlying stock increases in value as a result of a tender offer announcement or other news. This potential for immense profits is a powerful lure to this illegal activity. In one case, the Commission alleged that an individual purchased approximately $3 000 in call options of a corporation, which was to be the subject of a takeover proposal and, in 48 hours, realised a profit of approximately $430 000.

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It was first employed by the United States Justice Department in *Chiarella v United States*[241] in 1980. There, only four justices of the Supreme Court endorsed the theory. In *United States v Newman*,[242] a year later, the United States Court of Appeals for the Second Circuit accepted the misappropriation theory. It was only, however, until the *O'Hagan* decision that the Supreme Court, by reversing an Eighth Circuit decision that rejected the misappropriation theory, endorsed the theory and established it as a basis for insider trading regulation. The development has pervaded thinking on insider trading globally.

Our courts, albeit in contexts other than insider trading, have recognised principles that are akin to those recognised by the misappropriation theory. Whether a legal person has, for instance, a right to privacy, is no longer open to doubt.[243] The Constitutional Court has unequivocally stated in *Hyundai* that the exclusion of juridical persons from the right to privacy:

> would lead to the possibility of grave violations of privacy in our society, with serious implications for the conduct of affairs. The State might, for instance, have free license to search and seize material from any non-profit organisation or corporate entity at will. This would obviously lead to grave disruptions and would undermine the very fabric of our democratic State. Juristic persons therefore do enjoy the right to privacy, although not to the same extent as natural persons.[244]

South African law also recognises the principle that information can be used in such a way that it amounts to unfair competition. It is a duty that weighs more heavily on the top management of a company, but it also rests on the shoulders of mere employees.[245] The duty is a corollary of the principle that states that an employee, or someone of higher rank, cannot obtain for

[241] 445 US 222 (1980).
[242] 664 F.2d. 12 (2d Cir. 1981).
[243] *Universiteit van Pretoria v Tommie Meyer Films (Edms) Bpk* 1979 (1) SA 441 (A) 295.
[244] *Investigating Directorate: Serious Economic Offences and Others v Hyundai Motor Distributors (Pty) Ltd and Others: In re Hyundai Motor Distributors (Pty) Ltd and Others v Smit NO and Others* 2001 (1) SA 545 (CC) pars. 22–24.
[245] *SA Historical Mint (Pty) Ltd v Sutcliffe* 1983 (2) SA 84 (CPD) 90D.

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himself a business opportunity or a business advantage that would have been the company's. It has been accepted in our law that an employee may not make use of information that has been entrusted to him in confidence in the course of his work and for the purposes of competing with his employer or former employer. In this regard it has also been held, on the one hand, that one cannot protect what is ordinary information while,[246] on the other, information is not necessarily protected simply because it relates to a trade secret. It has been held that at least one of the wrongs sought to be addressed by the rule is that 'if other competitors did not have equal access to such information, its unauthorised disclosure to and use by the defendant can be actionable unfair competition.[247]

All this arises from companies' entitlement as against all the world to carry on lawful business in a way that does not trespass upon the rights of others. Intentional interference with the transaction of such business to the detriment of the person concerned is an actionable *inuria*.[248] And our law's common law action for unlawful competition is to be found in, among other things, the filching of secret and confidential information by competitors[249] and the unlawful use of secret information.[250] Every person's conduct that interferes with the trader's right to carry on his lawful business may constitute unlawful competition.[251] Further, in connection with this, a company's right to trade without the wrongful interference from others encompasses the right to have the confidentiality of its internal communications respected.[252]

Also in this context, of the company's right to trade and carry on lawful business, a company is entitled to regard the confidential communications between directors and employees of the

[246] Ibid.
[247] Ibid. 90C.
[248] *G A Fichardt Ltd v The Friend Newspapers Ltd* 1916 AD 1 6.
[249] *Prok Africa (Pty) Ltd and Another v NTH (Pty) Ltd and Others* 1980 (3) SA 687 (W).
[250] *Dun v Bradstreet (Pty) Ltd v SA Merchants Combined Credit Bureau (Cape) (Pty) Ltd* 1968 (1) SA 209 (C); *Schultz v Butt* 1986 (3) SA 667 (A) 687H.
[251] *Sage Holdings Ltd v Financial Mail (Pty) Ltd* 1991 (2) SA 117 (W) 132F.
[252] Ibid. 132G.

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company as confidential and sacrosanct.[253] Companies may in appropriate circumstances enforce this right against whomsoever is in possession of confidential information and who seeks to utilise it.[254] Directors and officers of companies are, in South African law, not allowed to use for their own purposes, or to disclose, confidential information entrusted to them concerning their company's affairs.[255] Confidential information in this common law context includes but is not limited to information with direct commercial value, such as trade secrets and customer lists.[256]

The misappropriation theory, or at least principles akin to it, is therefore not foreign to our law. There are, nonetheless, other reasons why it must not be the basis for regulating insider trading, a market wrong, in our financial markets. Firstly, the misappropriation theory fails to explain the wrongfulness of the misappropriator's conduct relative to those with whom he deals.[257] The wrong is one committed against the company from which the information is misappropriated, not against the trader or traders with whom the misappropriator trades. As such, or secondly, if there is no breach of duty between a misappropriator and the source of the information, there is no unlawful conduct.[258] A person who, for instance, trades with the permission of the source of his inside information, whether it be an employee or otherwise, cannot fall foul of the misappropriation theory. Further, where a trader discovers information by other means, without there being any relationship between a trader and a source, the trader

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253 Ibid. 132I.

254 *Sage Holdings Ltd v Financial Mail (Pty) Ltd* 1991 (2) SA 117 (W) 132–133; *Financial Mail (Pty) Ltd v Sage Holdings Ltd* 1993 2 SA 451 (A) 464; *Janit v Motor Industry Fund Administrators (Pty) Ltd* 1995 4 SA 293 (A) 303.

255 See *Sibex Construction (SA) Pty Ltd v Injectaseal CC* 1988 (2) SA 54 (T).

256 See *Coolair Ventilator Co v Liebenberg* 1967 (1) SA 686 (W); *Harvey Tiling Co (Pty) Ltd v Rodomac (*Pty) Ltd 1977 (1) SA 316 (T); *Prok Africa (Pty) Ltd v NTH (Pty) Ltd* 1980 (3) SA 687 (W); *SA Historical Mint (Pty) Ltd v Sutcliffe* 1983 (2) SA 84 (C); *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano* (Pty) Ltd 1981 2 SA 173 (T); *Multi Tube Systems (Pty) Ltd v Ponting* 1984 (3) SA 182 (D); *Sibex Construction (SA) Pty Ltd v Injectaseal CC* 1988 (2) SA 54 (T); *Knox D'Arcy Ltd v Jamieson* 1992 (3) SA 520 (W*); Van Castricum v Theunissen* 1992 (2) SA 726 (T); *Knox D'Arcy Ltd v Jamieson* 1995 2 SA 579 (W).

257 Blackman et al *Commentary on the Companies Act* (Revision Service 6 2009) 5-376-1.

258 J R Beeson "Rounding the peg to fit the hole: a proposed regulatory reform of the misappropriation theory" (1995) 144 *U Pa L Rev* 1077 1135–7.

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would be free to trade. For instance, where a trader would come upon information fortuitously, he would be free to trade.[259] Even worse, were someone to steal the information, without there being any prior duty owed to the source, the thief would not be liable for his subsequent trade under the misappropriation theory.[260]

Third, it is difficult to determine when and from what the duty owed to the source arises.[261] Whereas it is recognised that the duty to the source is not fiduciary in nature and that it arises in cases where an express confidentiality agreement is concluded, very little else is concrete. So the theory fails to provide a clear bright line for culpability. That bright line, dividing lawful and unlawful conduct, is sorely needed in the financial markets.[262] Fourth, the theory arbitrarily regulates some instances of unfair trading while turning a blind eye to others. The misappropriation theory says, among other things, this: some persons may trade on inside information and others may not. If there is no misappropriation vis-à-vis the source, the trader will be free to trade.[263] In that way, much like the fiduciary doctrine, the misappropriation theory as basis for the regulation of trading on inside information, allows some to trade on inside information while others are barred. The theory could be said to give rise to injudicious, irrational and indeed, in our jurisdiction, unconstitutional results: actions that are identical for all relevant purposes with the same level of culpability are treated differently by the law.[264]

The misappropriation theory's answer to the question 'why are some allowed to trade on inside information and others are not?' is unsatisfactory and arbitrary in a market context. Its answer is: because some information was obtained in breach of a duty to the source of the information

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[259] Aldave (1984) *Hofstra L Rev* 122.

[260] Ibid. 101, 112 and 114–115.

[261] F H Easterbrook "Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information" (1981) 1981 *Sup Ct Rev* 309 321.

[262] Beeson (1995) *U Pa L Rev* 1357.

[263] It could be argued that trading with misappropriated information also damages the integrity of the capital market indirectly and that it therefore undermines the confidence in that market, to the detriment of all investors. See B B Aldave "Misappropriation theory: Carpenter and Its Aftermath" (1988) 49 *Ohio St LJ* 373 380 and the United State case of *Moss v Morgan Stanley Inc*. 465 U.S. 1025 (1984).

[264] Beeson (1995) *U Pa L Rev* 1357.

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and other information was not so obtained. The misappropriation theory does not protect primarily investors; it protects the source's property rights in information. The misappropriation theory fails in providing a market-based theory. Whereas it is not completely irreconcilable with a legislative commitment to the integrity of the capital market as it does, to a certain extent, address information asymmetries between traders, it does not address all of them. At least, unlike the fiduciary doctrine, it is able to explain the liability of directors even if they buy securities from traders to whom they do not yet, at the point of their purchase, owe a fiduciary duty. The misappropriation theory is also capable of extending the prohibition on trading on inside information to outsiders who are not fiduciaries of the company's shareholders.[265]

The misappropriation theory's biggest failure is that it fails to address many scenarios in which an information advantage is obtained unfairly in a market context.[266] This inevitably leads courts to find ways to circumvent the duty requirement. An interesting example of this is found in a judgment by the Ontario Securities Commission in *Re Paul Donald.*[267] The charge against Donald was that he had purchased the securities of a certain Certicom Corporation, while he stood in a special relationship to Certicom and while he had inside information about Certicom. The facts are briefly as follows. In 2008 Certicom was a provider of cryptography used by software vendors and wireless device manufactures, including Research in Motion (RIM), the well-known producer of BlackBerry devices. Certicom's technology added value to handheld communication devices as it provided for a high level of security. Donald started

265 Brodsky 1998 *Cardozo L Rev* 42. Also see Kidd 1993 *Del J Corp L* 106.

266 S S Kunkel "Insider trading: A new equal access approach" (1989) 15 *J Contemp L* 51.

267 In the matter of the Securities Act, R.S.O. 1990, c. S.5, as amended and In the matter of Paul Donald: Reasons and Decision (Subsection 127(1 of the Act) reported at http://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_20120801_donaldp.pdf. ("*Re Donald*").

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to work at RIM in May 1999 and held several positions during the course of his employment. When Donald made the impugned trades, he was a vice president of one of RIM's divisions.[268]

In August of 2008 RIM hosted a golf tournament and dinner for its executives. During the dinner Donald had a conversation about Certicom with one of RIM's other vice presidents, one Wormald. During this conversation, it was alleged, Donald became aware of inside information relating to Certicom. From the following day, for a period of about a month, Donald acquired securities in Certicom.[269] Roughly five months later RIM announced that it would acquire all of Certicom's shares. Donald realised a handsome profit.[270]

The Commission argued that Donald was a person in a special relationship with Certicom when he purchased Certicom securities in August 2008 and September 2008 as, firstly, Donald was an officer and employee of RIM at a time when it was a company proposing to make a takeover bid for Certicom's shares.[271] Secondly, Donald was an officer and employee of RIM at a time when it was a company proposing to become a party to a reorganisation, amalgamation, merger or arrangement or similar business combination with Certicom or to acquire a substantial portion of its property.[272] Thirdly, it was argued that Donald was an officer and employee of RIM and that the company was engaging in or proposing to engage in business or professional activity with Certicom.[273] Fourthly, it was alleged that Donald learned of a material fact about Certicom from Wormald, who was an officer and employee of RIM at

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[268] *Re Donald* par. 5.
[269] *Re Donald* par. 7.
[270] *Re Donald* par. 8.
[271] *Re Donald* par. 210(a). This argument is based on section 76(5)(c) and 76(5)(a)(ii) of the Ontario Securities Act.
[272] *Re Donald* par. 210(b). This argument was based on sections 76(5)(c) and 76(5)(a)(iii) of the Ontario Securities Act.
[273] *Re Donald* par. 210(c). This argument was based on sections 76(5)(c) and 76(5)(b) of the Ontario Securities Act.

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the time that it was a company proposing to make a takeover bid for Certicom.[274] Fifthly, Donald learned of a material fact about Certicom from Wormald, who was an officer and employee of RIM at a time when RIM was a company proposing to become a party to a reorganisation, amalgamation, merger or arrangement or similar business combination with the reporting issuer or to acquire a substantial portion of its property.[275]

As to the first argument, the Commission found that, as of the date of the 2008 golf event and the day after it, when Donald placed his order to purchase the Certicom shares, RIM's interest in acquiring Certicom had not evolved into a proposal to do so. The evidence, therefore, did not establish that the company had made a decision that it should or would be proposing a takeover bid to acquire Certicom within the meaning of the Ontario Securities Act.[276]

As to the second argument, the Commission placed specific emphasis on the fact that there were no active discussions underway between Certicom and RIM about a reorganisation, amalgamation, merger or arrangement or similar business combination. The Commission found that RIM had not made a decision to propose a takeover bid or business combination with Certicom in order for the relevant section in the Ontario Securities Act to apply.[277] On those facts, the Commission's second argument for founding a special relationship too had to fail.

Concerning the third argument, the Commission took note of the fact that RIM had an ongoing business relationship with Certicom since May of 2000, as it was then that RIM first started to license Certicom's toolkits. They had furthermore engaged in business when discussing the

[274] *Re Donald* par. 210(d). This argument was based on sections 76(5)(e), 76(5)(c) and 76(5)(a)(ii) of the Act.
[275] *Re Donald* par. 210(e). This argument was based on sections 76(5)(e), 76(5)(c) and 76(5)(a)(iii) of the Ontario Securities Act.
[276] *Re Donald* par. 229.
[277] *Re Donald* par. 233–234.

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possibility of an acquisition in the period following the initial meeting in February 2007. The Commission found that the fact that RIM had been licensing Certicom's technology since the year 2000 was not a sufficient basis on which to conclude that Donald was in a special relationship with Certicom.[278]

The fourth and fifth arguments of the Commission to found a special relationship were dealt with shortly. As to the fourth, the Commission found that, had it found that RIM was proposing to make a takeover bid for Certicom or proposing to enter into some other business relationship with Certicom, it would have concluded that Donald, as an officer and employee of RIM, was in a special relationship with Certicom. As it, however, found that RIM was not in a special relationship with Certicom, it followed, according to the Commission, that it could not be concluded that Donald was in a special relationship with Certicom in his capacity as an officer or employee of RIM.[279] Donald could also not be held liable as a tippee as Wormald was not in a special relationship with Certicom.[280]

The Commission therefore found that Donald also did not stand in a special relationship with Certicom. Should the wording of the Act, and its requirement for insider trading liability, or quasi insider trading liability, have been applied strictly, this should have been the end of the matter. The Commission, however, did not stop there. It was argued before the Commission that it had 'public interest jurisdiction' to make an order under the Ontario Securities Act 'regardless of whether there had been a breach of the Act.'.[281] This argument was based on 'the principle that market participants should conduct themselves ethically and honestly'.[282] Despite the fact that Donald could not be found to have stood in some sort of special

[278] *Re Donald* par. 239.
[279] *Re Donald* par. 240.
[280] *Re Donald* par. 242.
[281] *Re Donald* par. 289. This argument was based on what was found in *Re Canadian Tire Corp* (1987) 10 O.S.C.B. 857 and *Re Biovail Corp* (2010) 33 O.S.C.B. 8914.
[282] *Re Donald* par. 289.

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relationship with the issuer, it was argued, his conduct was contrary to the public interest.[283] Among other things, Donald's behaviour was said to fall below the 'standard of ethical behaviour required of market participants'[284] and that:

> Donald's purchases of Certicom shares caused harm to the integrity of Ontario capital markets in general because he was an officer of a reporting issuer and *a market participant who knew or should have known not to purchase Certicom shares in the circumstances. . . . Donald made these purchases when he had information that the market did not have and his conduct accordingly lessened the confidence of the investing public in the marketplace, and is therefore a matter of public concern.*[285] (Emphasis added.)

The Commission concluded that although it did not technically find a breach of section 76(1) of the Ontario Securities Act, Donald's purchases of the Certicom shares called for the application of the fundamental principles of securities regulation and the purposes of the Ontario Securities Act. For even though there was no special relationship between Donald and the issuer, '[his] conduct was abusive of the capital markets and to confidence in the capital markets'.[286]

The Commission's finding is a clear recognition of the fiduciary doctrine and the misappropriation theories' failure in regulating insider trading in the capital markets. It recognises that a different theory, which prohibits all 'conduct abusive of the capital markets and to confidence in the capital markets', is required for the regulation of insider trading.

In my submission, the misappropriation theory fails to provide a basis for the regulation of insider trading for the same reason the fiduciary duty doctrine fails to do so: both seek to address a market wrong by finding the unlawfulness of the conduct they seek to prohibit

[283] *Re Donald* par. 291.
[284] *Re Donald* par. 297.
[285] *Re Donald* par. 295–298.
[286] *Re Donald* par. 323–324.

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outside of the market. Both bases for regulation require artificial legal reasoning to connect a breach of duty unrelated to the market, to harm done to investors in the market and the market itself.[287] For instance, if one were to recognise a civil action by an aggrieved trader, what would be his cause of action? According to the misappropriation theory, the wrong was done to the source of the information. The theory operates by holding x liable for an act that harmed y, whereas the wrongfulness is found in a breach of duty owed to z. At most one could say that trading on misappropriated information is indirectly harmful to confidence in the financial markets, but this does not give the aggrieved trader an action – it merely affords an action to the regulatory body responsible for seeing to the integrity of the market. It is a roundabout way of trying to ensure relatively equal access to information to all traders in the financial markets. It brings at least some respite to fiduciary 'doctrinal rigidity'.[288]

The misappropriation theory was, however, never conceived or formulated with the object of creating a self-standing basis of regulation by a legislature seeking to address a market wrong. At most, the misappropriation theory can be seen as a corollary of the fiduciary doctrine,[289] but it is most properly seen as a compromise between the fiduciary doctrine and the equal access to information theory.[290] As it has been said, it was rather born out of among other things a judicial obstinacy in not recognising a market-based theory to serve as the regulatory

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[287] Beeson (1995) *U Pa L Rev* 1138.

[288] D C Langevoort "The Insider Trading Sanctions Act of 1984 and its effect on existing law" (1984) 37 *Vand L Rev* 1273

[289] M G Dworkin "Misappropriation Theory as a Corollary to the Classic Insider Trading Theory" (1996) 1996 *Am Surv Am L* 315 359-364. M B Haire "The Uneasy Doctrinal Compromise of the Misappropriation Theory" (1998) 73 *NYU L Rev* 1251 1252 views the misappropriation theory as a 'sort of hybrid model' composed of parts of the fiduciary duty doctrine and the equal access to information theory. Furthermore, the author writes that

> [a]t first glance, this doctrinal theory appears an odd compromise between the fiduciary duty and equal access models of insider trading liability. On the one hand, like the duty model liability under the theory is predicated on a breach of fiduciary duty (namely, that which the trader owed to the source of the non-public information). On the other hand, like the equal access model, the theory applies to investors who do not stand in a fiduciary relationship with the market participants with whom they trade. (1253)

Also see L E Mitchell "The Jurisprudence of the Misappropriation theory and the new insider trading legislation: From fairness to efficiency and back" (1988) 52 *Alb L Rev* 775 826 where the author notes that the 'misappropriation theory was born schizophrenic'.

[290] See Haire (1998) *NYU L Rev* 1252.

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basis for trading on inside information enactments. Indeed, it could be said that it is purely the United States Supreme Court's obstinacy, working through its strong influence on other jurisdictions in securities market law, that has contributed most to the convoluted state of insider trading law in Commonwealth countries. It has led our legislative provisions, as others in the world, to be left stuck with one foot in the fiduciary duty doctrine and one foot in the misappropriation theory.

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2 2 3 Reluctance to accept a market theory

Unites States jurisprudence, including the judgments of its Supreme Court, evidences an obstinacy in accepting a market-based theory for the regulation of insider trading.[291] The country's jurisprudence is also testament to the anomalous results the fiduciary doctrine and the misappropriation theory give rise to.

2 2 3 1 In Re Cady, Roberts & Co[292]

In the SEC opinion in the matter of *Cady, Roberts & Co* (*Cady, Roberts*), the SEC dealt with an application to suspend a stockbroker from operating on a securities exchange. The matter involved a selling stockbroker who traded for the accounts of others, including that of his wife. The question the commission considered was: what is required of a stockbroker (not a director or an officer of an issuing firm) when he receives inside information from a director employed by the same brokerage firm as the stockbroker?

The proceedings were brought on the strength of section 10(b) of the Securities Exchange Act and Rule 10b-5. The impugned trading was that of Cady, Roberts & Co and more specifically one of its brokers, and a partner in the firm, Gintel. In November of 1959, one Hurley, then

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[291] For the intellectual history of insider trading regulation in the United States see S M Bainbridge "Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud" (1999) 52 *SMU L Rev* 1589; Langevoort (1999) *Colum L Rev* 1319; Langevoort (1995) *Del J Corp L* 865; Macey (1984) *Hofstra Law Review* 13–29; Seligman (1985) *Geo LJ* 1083; Fisch (1992) *Ga L Rev* 179; Langevoort (1985) *Nw U L Rev* 261–262.

[292] *In the matter of Cady, Roberts & Co* 40 SEC 907 (1961). For academic reactions to the decision see F A Daum & H W Phillips "The implications of Cady, Roberts" (1962) 17 *Bus Law* 939; E V Hines "A New Concept of Fraud on the Securities Exchange – A Comment on In Re Cady Roberts & Co." (1962) 15 *SCL Rev* 557; J M Whitney "Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure" (1965) 21 *Bus Law* 193. For a discussion on the ideology underlying the SEC's decision and the effect of the decision in general, see Langevoort (1990) *Colum L Rev* 1319 and C W Davis "Misappropriators, Tippees and the Intent-to-Benefit rule: What we can still learn from Cady, Roberts" (2004) 35 *Seton Hall L Rev* 263.

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president of the board of the Curtiss-Wright Corporation, invited representatives of the press, the United States military, and financial and business institutions for the public unveiling of a then new type of internal combustion engine the company had developed. On 24 November 1959 announcements about the new engine were made in the media. Demand for Curtis-Wright stock rose and its New York Stock Exchange (NYSE) share price rose considerably throughout the day.

Of the 88 700 Curtis-Wright shares traded from 3 November 1959 through to the 23rd, Gintel had purchased approximately 11 000 shares. Gintel was purchasing for certain discretionary accounts of customers of Cady, Roberts & Co. After the rise in price on 24 November, he began selling the shares. On the morning of the 25th, the Curtis-Wright directors met to consider the declaration of a quarterly dividend. Sometime after the directors had decided to declare a lesser dividend than that declared in the immediately preceding quarters, a party to the directors' meeting phoned Gintel and informed him of the decision. Gintel proceeded to enter two further large sale orders for execution on the NYSE.

In delivering its opinion, the SEC summarised the United States disclose or abstain rule, as follows:

> An affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders', particularly officers, directors or controlling shareholders. We, and the courts, have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitute a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to affecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forgo the transaction.[293]

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[293] *In re Cady, Roberts & Co* 40 SEC 907 (1961) 913.

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The Commission found both Gintel and Cady, Roberts & Co, in its capacity as Gintel's employer, guilty of a violation of section 10(b) and Rule 10b-5. Importantly, in coming to its conclusion, it rejected Cady, Roberts & Co's contentions that an insiders' responsibilities are limited to existing stockholders and that an insider owes no special duties to non-stockholders. The Commission found that:

> [that] approach is too narrow. It ignores the plight of the buying public – wholly unprotected from the misuse of special information. Neither the statutes nor rule 10b-5 establish an artificial wall of responsibility. . . . There is no valid reason why persons who purchase stock from an officer, director or other person having the responsibilities of an 'insider' should not have the same protection afforded by disclosure of special information as persons who sell the stock to them. *Whatever distinction may have existed at common law based on the view that an officer or director may stand in a fiduciary duty relationship to existing stockholders from whom he purchases but not the members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.*[294] (Emphasis added.)

The language used in *Cady, Roberts* pointed to an acceptance of the fact that one does not necessarily require a fiduciary relationship in order to found liability for trading on inside information. The Commission relied on two factors to impose the duty to disclose on the corporate insiders: 1) '. . . access . . . to information intended to be available only for a corporate purpose and not for the personal benefit of anyone'; and 2) the premise that it is inherently unfair to trade on information that is inaccessible to those with whom one is dealing.[295]

The SEC's opinion in *Cady, Roberts* was an important step in the development of the United States jurisprudence on insider trading. Firstly, it was credited with the formulation of the 'disclose-or-abstain' rule. In essence the rule provides that, when in possession of inside information about shares in which an insider wants to trade, he must either disclose this information to a counterparty to a trade or abstain from trading. Secondly, and more importantly for the purposes of this thesis, it was held that a broker-dealer and his firm, not

[294] Ibid. 913–914.
[295] See also Justice Burger's dissent in *Chiarella v United States* 445 US 222 (1980) 242.

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owing any fiduciary duty to the shareholders of the shares they traded in, violated section 10(b), by selling the securities on the strength of undisclosed information received from a director of the issuer corporation.[296] If the judgment is seen as a step toward the acceptance of a market theory of regulation in the United States,[297] the journey has never been completed. The United States Supreme Court did not accept the reasoning in *Cady, Roberts* as it will be seen.

2 2 3 2 SEC v Texas Gulf Sulphur[298]

The SEC's approach in *Cady, Roberts* was, however, accepted and applied by the United States Court for the Second Circuit in *SEC v Texas Gulf Sulphur*.[299] The charge against Texas Gulf Sulphur (TGS) and several of its officers, directors, and employees, was essentially that they had traded with, encouraged to trade on, tipped and accepted inside information relating to

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296 *Chiarella v United States* 445 US 222 (1980).

297 See for instance *In re Blyth & Co* 43 SEC 1037 (1969) where the principles set out in *Cady, Roberts* were again applied by the Commission and its focus was on the 'improper use of inside information'. (1040).

298 *SEC v Texas Gulf Sulphur* 401 F 2d 833 (1968).

299 *SEC v Texas Gulf Sulphur* 401 F 2d 833 (1968). For discussions of this decision see A Fleischer "Securities Trading and Corporate information practices: The implications of the Texas Gulf Sulphur proceeding" (1965) 51 *Va L Rev* 1271; D S Ruder "Texas Gulf Sulphur – The second round: privity and state of mind in Rule 10b-5 purchase and sale cases" (1968) 63 *Nw Ul Rev* 423; W M Kennedy & H S Wander "Texas Gulf Sulphur, A Most Unusual Case" (1964) 20 *Bus Law* 1057; J L Wiesen "Disclosure of Inside Information – Materiality and Texas Gulf Sulphur" (1968) 28 *Md L Rev* 189; G Sandler & A F Conwill "Texas Gulf Sulphur, Reform in the Securities Marketplace" (1969) 30 *Ohio St LJ* 225; J M Whitney "Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure" (1965) 21 *Bus Law* 193; J Osborn "Texas Gulf Sulphur: A vigorous assault on insider trading and misleading press releases" (1969) 11 *Ariz L Rev* 290; E B Frost "SEC Enforcement of the Rule 10b-5 duty to disclose material information: remedies and the Texas Gulf Sulphur case" (1966) 65 *Mich L Rev* 944; A R Bromberg "Are There Limits to Rule 10b-5?" (1973) 29 *Bus Law* 167; P M Nielson "So what else is new in the law – Texas Gulf Sulphur restates Peek v Gurney" (1971) 1971 *Utah L Rev* 327; D M Schuyler "From Sulphur to Surcharge? – Corporate Trustee Exposure under SEC Rule 10b-5" (1972–1973) 67 *Nw U L Rev* 42; D S Ruder "Current Developments in the Federal Law of Corporate Fiduciary Relations – Standing to Sue under Rule 10b-5" (1970) 26 *Bus Law* 1289; T J Schoenbaum "Relationship between corporate disclosure and corporate responsibility" (1971) 40 *Fordham L Rev* 565; R B Titus & P G Carrol "Netting the Outsider: The Need for a Broader Restatement of Insider Trading Doctrine" (1986) 8 *W New Eng L Rev* 127.

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drilling test results. TGS began exploring the possibilities of mining on the Canadian Shield in 1957. In the beginning of 1959 a group, including many of the defendants in the case, conducted aerial geophysical surveys over a large part of this area. They found numerous anomalies, including extraordinary variations in the conductivity of rocks on a piece of land known as the Kidd 55 segment.

The findings roused interest, and in October 1963 the men were back to conduct further tests on certain sections of Kidd 55. They drilled, and large deposits of minerals were found. TGS was therefore convinced that they had to acquire the remainder of the Kidd 55 segment. In order to facilitate the purchase, the president of TGS instructed the group of explorers to keep the results of their drilling confidential. As soon as TGS's land acquisition plans had advanced far enough, the company resumed drilling. Those who knew of the rich deposits and TGS's success in securing the land, purchased TGS shares and share call options. The court reasoned as follows:

> *anyone* in possession of material inside information must either disclose it to the investing public or, . . . [if] he chooses not to do so, he must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[300] (Emphasis added)

And, that:

> [b]y [the 1934] Act Congress proposed to prevent inequitable and unfair practices and to insure fairness in securities transactions and generally, whether face-to-face, over the counter or on exchanges . . . . *[T]he Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information*. . . . The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone may not take advantage of such information knowing it is unavailable to those with whom he is dealing.[301] (Citations omitted and emphasis added.)

[300] *SEC v Texas Gulf Sulphur*, 401 F.2d 833 (1968) 848.
[301] Ibid.

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With this endorsement of the equal access to information theory, a market related theory described below, the SEC pursued a more vigorous prosecution against non-traditional insiders trading on inside information.[302] The United States Supreme Court stepped in, rejected the equal access theory and adopted a much narrower fiduciary duty standard in *Chiarella v United States*[303] and *Dirks v SEC*.[304] After these two decisions the United States legislative prohibition on insider trading was limited to traditional corporate insiders and certain tippees. If confidence in the capital markets were the SEC's main objective and that confidence were dependent on the prohibition of all trading on inside information, these two decisions severely hampered the SEC in pursuing its main objective.[305]

2 2 3 3 Chiarella v United States

Chiarella v United States[306] deals with an 'outsider's' liability for trading on material non-public information. The case presented the Supreme Court of the United States with the

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302 Kunkel (1989) *J Contemp L* 51; R M Phillips & R J Zutz "The insider trading doctrine: a need for legislative repair" (1984) 13 *Hofstra L Rev* 65 74; and *Investors Management Co* 44 SEC 633 (1971) and *United States v Chiarella* 588 F 2d 1358 (1978).

303 445 US 222 (1980).

304 463 US 646 (1983).

305 See for example *SEC v Switzer* 590 F Supp 756 (W.D. Okla 1984) and *United States v Reed* 601 F Supp 685 (SDNY 1985).

306 445 US 222 (1980) (*Chiarella*). For discussions of the case see K C Feffer "Chiarella v United States" (1981) 15 *Loy LAL Rev* 177; W A Cann "A Duty to Disclose – An Analysis of Chiarella v United States" (1980) 85 *Dick L Rev* 249; M T Galero "Drawing the line on insiders and outsiders for rule 10b-5: Chiarella v United States" (1981) 4 *Harv JL. & Pub. Pol'y* 203; H Heller "Chiarella, SEC Rule 14e-3 and Dirks: Fairness v Economic Theory" (1981) 37 *Bus Law* 517; P E Stem "Chiarella v United States: The Supreme Court's Common Law Catch to Market Insider Liability under 10b-5" (1980) 14 *J Marshall L Rev* 847; T L Hazen "United States v Chestman – Trading in Securities on the Basis of Nonpublic Information in Advance of a Tender Offer" (1991) 57 *Brook L Rev* 595; J R Macey "Good finance, bad economics: an analysis of the fraud-on-the-market theory" (1989) 42 *Stand L Rev* 1059; G Schneider "Chiarella v United States: An analysis of judicial approaches to the regulation of business conduct" (1981) 17 *New Eng L Rev* 61; B B Aldave "Misappropriation Theory: Carpenter and Its Aftermath" (1988) 49 *Ohio St LJ* 373; A G Anderson "Fraud, Fiduciaries, and Insider Trading" (1981–1982) 10 *Hofstra L Rev* 341; J D Cox "Choices Paving the Road Toward a 'Definition' of Insider Trading" (1987–1988) 39 *Ala L Rev* 381; D C Langevoort "Words from on high about rule 10b-5: Chiarella's history, Central Bank's Future" (1995) 20 *Del J Corp L* 865.

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opportunity to confirm the equal access approach set upon in *Cady, Roberts & Co* and *Texas Gulf Sulphur*. The court did not do so. Instead it restricted the basis of liability for trading with inside information, holding that there is no 'general duty between all participants in market transactions to forgo actions based on material non-public information'[307] and that such a duty 'only arises from a specific relationship between two parties'.[308]

Chiarella was a printer by trade. In the mid-70s he worked as a 'mark-up man' in the composing room of a New York financial publications printer. Among the documents that Chiarella came across, were five announcements of corporate takeover bids. The identities of the acquiring and target corporations were concealed in the documents with which Chiarella dealt. Names were redacted or replaced with false names. The true names were sent to the printer only on the night of the final printing of the announcements.

Chiarella nevertheless managed to find out the names of the target companies before the final printing, by deducing the names of the relevant corporations from other information in the documents. He then purchased shares in the target companies and, as soon as the financial publication containing the takeover announcements was published, he sold his shares, realising a handsome profit.[309] An SEC investigation followed, Chiarella was brought to trial, and he was convicted on all 17 counts of violating section 10(b) of the Securities Exchange Act and Rule 10b-5. His convictions were affirmed on appeal.[310] The United States Supreme Court, however, reversed.

Chiarella had traded on the information he gathered from documents received in the course of his employment and, when he traded, he traded on information that his counterparty had no

[307] *Chiarella* 233.
[308] Ibid.
[309] Ibid. 224. It is recorded in the judgment that Chiarella realised a gain of more than $30 000 in the course of 14 months.
[310] 588 F 2d 1358 (1978).

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lawful means to obtain. He was not what is generally understood as a 'corporate insider' and he had not received any confidential information from any of the target companies. Was Chiarella subject to an affirmative duty to disclose the information he held before trading? Or, did the United States' law recognise a broader duty, one that required Chiarella to make disclosure to the counterparties to his trades?

The trial court and the court of appeal thought that United States law recognised such a broader duty. In the trial court the jury had been instructed that Chiarella owed a duty to everyone, indeed to the market as a whole, along equal access lines. All the jury had to decide was whether Chiarella traded using material, non-public information at a time when he was aware of the fact that other people trading in the market did not have access to the same information.[311] The jury answered in the affirmative.

The court of appeal affirmed the conviction and reasoned along the same lines. It held that 'anyone—corporate insider or not—who regularly receives material non-public information may not use that information to trade in securities without incurring an affirmative duty to disclose'.[312] It held that the United States federal securities laws had 'created a system providing *equal access to information* necessary for reasonable and intelligent investment decisions'.[313] (Emphasis added.) Chiarella was found guilty of contravening the rules of that system.

The United States Supreme Court strictly applied section 10(b). It held that the proposition, supposedly found in the lower courts' reasoning, that '[t]he use by anyone of material information not generally available is fraudulent … because such information gives certain

311 *Chiarella* 231.
312 *United States v Chiarella* 588 F 2d 1358 (1978) 1365.
313 Ibid. 1362.

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buyers an unfair advantage over less informed buyers and sellers',[314] unacceptable. Firstly, it held that not all forms of 'financial unfairness' constituted fraud. Secondly, it reasoned that one of the elements required to make silence fraudulent—a duty to disclose—was absent.[315] Chiarella owed no duty to the sellers of the securities in the target companies, found the court, as he was in no way connected to them nor had he any prior dealings with them.[316] Indeed, his trades were acceptable as, '[h]e was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions'.[317] The court wrote:

> We cannot affirm petitioner's conviction without recognising a general duty between all participants in market transactions to forgo actions based on material non-public information. The formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties … should not be undertaken absent some explicit evidence of congressional intent.

It held itself bound by the language of the statute, its legislative history and the congressional intent behind it, for 'neither Congress nor the Commission ever has adopted a parity-of-information rule'.[318] The United States Congress's careful conduct in the area of insider trading and the use of material non-public information was, it found, in contrast with the broad rule of liability that had been accepted by the lower courts in the case.[319]

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[314] That is not the equal access to information theory I am arguing for. That summation would be better suited to a theory calling for information parity.

[315] *Chiarella* 232.

[316] Ibid.

[317] Ibid. 232–233.

[318] Ibid. 233. The court held that instead of such a parity of information rule, the 'problems caused by misuse of market information have been addressed by detailed and sophisticated regulation that recognizes when the use of market information may not harm operation of securities markets'. At that time it gave the Williams Act as an example of such 'sophisticated regulation'. The Williams Act permitted a tender offer to purchase only 5% of the target company's stock prior to the disclosure of its plan for acquisition.

[319] Ibid. 234.

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Justice Stevens, in his separate concurring judgment, agreed with the finding that Chiarella owed no duty of disclosure to the sellers of the shares and further agreed with the majority of the court's finding that it was not open to the court to enter into the enquiry of whether the breach of a duty to Chiarella's employer could found liability under section 10(b). Justice Stevens concluded his judgment with the following remark:

> I write simply to emphasize the fact that we have not necessarily placed any stamp of approval on what this petitioner did, nor have we held that similar actions must be considered lawful in the future. Rather, we have merely held that petitioner's criminal conviction cannot rest on the theory that he breached a duty he did not owe.[320]

Justice Brennan, in a separate judgment, concurred with the majority's holding that a duty to disclose did not arise from the mere possession of non-public material information.[321] He, however, agreed with dissenting Chief Justice Berger's statement of the United States substantive law that a person violated section 10(b) whenever he 'improperly obtains or converts to his own benefit non-public information', which he then used to enable him to profitable trade in shares.[322]

Chief Justice Berger held that the jury instructions, being that the use of material non-public information in this case was enough to found liability, properly founded a violation of section 10(b) and Rule 10b-5. As a point of departure, the Justice noted that neither party to an arm's length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation to one another. Accordingly, a businessman is permitted to capitalise on his experience and skill in securing and evaluating

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[320] Ibid. 238.
[321] Ibid. 238–239.
[322] Ibid. 239.

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relevant information.[323] His advantage, however, should be the result of hard work, careful analysis and astute forecasting.[324]

But this rule that experienced and learned individuals should be allowed to reap the rewards of their expertise and learning cannot, according to Justice Berger, mean that those in the know have an unfettered right to trade with those that are not. The rule should be limited in its scope: 'the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means'.[325] Therefore, held Justice Berger, 'a person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading'.[326] The Justice pointed out that the broad language of section 10(b) and Rule 10b-5 negated the majority's suggestion that the United States Congress's concern was limited to trading by 'corporate insiders'. An investor who purchased securities on the basis of misappropriated information possessed an undue trading advantage, which served no useful function except self-enrichment at the expense of others.[327]

Justice Blackmun,[328] also finding it necessary to write, found that it was unnecessary to base Chiarella's conviction on a 'misappropriation theory'. The Justice held that he would have been willing to convict Chiarella even if he had not been guilty of 'stealing' the information and even if Chiarella had obtained the information with his employer's blessing. For he held

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[323] Ibid. 239–240.

[324] Ibid. 240.

[325] Ibid. 240. Justice Burger, in making this point, quotes a passage from W P Keeton "Fraud – Concealment and Non-Disclosure" (1936) 3 *Texas L Rev* 25–26 where the author deals with United States law on the subject. I repeat the quote here:

> [T]he way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The information might have been acquired as a result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by mere chance; or it might have been acquired by means of some tortious action on his part . . . *Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information*. (Emphasis that of Justice Burger.)

[326] *Chiarella* 240.

[327] Ibid. 242.

[328] Justice Marshall concurred in Justice Blackmun's opinion.

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that Chiarella's 'brand of manipulative trading, with or without such approval, lies close to the heart of what the securities laws are intended to prohibit'.[329] Justice Blackmun took a bold step towards a market-based theory of regulation. He wrote:

> The Court continues to pursue a course, charted in certain decisions, designed to transform section 10(b) from an intentionally elastic "catchall" provision to one that catches relatively little of the misbehaviour that too often makes investment in securities a needlessly risky business for the uninitiated investor. Such confinement in this case is now achieved by imposition of a requirement of a "special relationship" akin to fiduciary duty before the statute gives rise to a duty to disclose or to abstain from trading upon material, non-public information.[330] (Footnotes omitted.)

The failure to disclose could not amount to a breach of section 10(b) only when the duties flowing from a special relationship have been breached. The majority, according to Justice Blackmun, unduly minimised the fact that Chiarella had used information that the honest investor, 'no matter how diligently he tried', could not obtain by employing legal means. Chiarella had access to material information and he knew the information was unavailable to those with whom he dealt. He took the full and, for all intents and purposes, zero-risk advantage by selling the stock shortly after the takeover bid was announced. For that and for that alone, found Justice Blackmun, should he be held liable for his conduct.

Chiarella is said to have changed the once prevailing understanding of the United States disclose or abstain rule, to have given greater clarity to United States insider trading theory and to have narrowed the scope of its applicability.[331] Yet, in effect, it was a judgment in which the Supreme Court failed properly to answer pressing questions surrounding the failings of the classic fiduciary and misappropriation insider trading theories.[332] It could have taken a

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[329] *Chiarella* 246.
[330] Ibid.
[331] *Langevoort on insider trading* (Rel 7/2009) 1:20.1.
[332] S Prakash "Our Dysfunctional Insider Trading Regime" (1999) 99 *Colum L Rev* 1501.

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progressive step in regulating insider trading. Instead, Justice Blackmun cut a lone figure on the otherwise fiduciary-duty minded Bench.

According to Branson[333] many viewed the United States founding legislative enactments on insider trading as being based on the idea that all participants in the securities markets must be on the same 'potential informational footing'.[334] The enactments, specifically Rule 10b-5, were supposed to be a great leveller. They were to promote public confidence in the ability of investors, especially individual investors, to participate in the securities market on an equal footing to their more sophisticated counterparties.[335] According to this view, *Chiarella* was a missed opportunity for the Supreme Court to recognise as much.[336] The court, instead, followed its previous judgments on the issue.[337]

2 2 3 4 United States v O'Hagan[338]

O'Hagan presented the court with a factual scenario wherein no traditional fiduciary duty was owed, while all else suggested that O'Hagan should be held liable. The table was therefore set for the United States court to embrace the misappropriation theory. It obliged.

[333] D M Branson "Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading" (1981) 30 *Emory LJ* 263.
[334] Branson (1981) *Emory LJ* 271.
[335] Ibid.
[336] Ibid.
[337] Ibid.
[338] 521 US 642 (1997) (*O'Hagan*). For articles reacting to the United States Supreme Court's formulation of the misappropriation theory in *O'Hagan,* see C B Swanson "Reinventing insider trading: The Supreme Court misappropriates the misappropriation theory" (1997) 32 *Wake Forest L Rev* 1157; K D Krawiec "Fiduciaries, Misappropriators and the Murky Outlines of the Den of Thieves: A Conceptual Continuum for Analyzing United States v. O'Haganagan" (1997) 33 *Tulsa LJ* 163; S M Bainbridge "Insider Trading Regulation: The path dependent choice between property rights and securities fraud" (1999) 52 *SMU L Rev* 1589; R W Painter, K D Krawiec & C A Williams "Don't ask, just tell: insider trading after United States v O'Hagan" (1997) 84 *Va L Rev* 153.

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O'Hagan was a partner in a Minnesota law firm, Dorsey & Whitney. In 1988 a company based in London, Grand Metropolitan PLC, retained O'Hagan's law firm as its local counsel in relation to a potential offer for the stock in the Pillsbury Company, a Minnesota corporation. O'Hagan was not part of the team within Dorsey & Whitney that represented Grand Metropolitan. Both Dorsey & Whitney and Grand Metropolitan took precautions in keeping information relating to the offer confidential. Less than three months after being appointed by Grand Metropolitan, Dorsey & Whitney terminated Grand Metropolitan's appointment. Less than a month after the termination, Grand Metropolitan announced its offer for Pillsbury's shares.

While Dorsey & Witney was still representing Grand Metropolitan, O'Hagan began purchasing call options for Pillsbury shares. Each of these options gave him the right to purchase a 100 Pillsbury shares at a specified future date. He continued to make additional purchases until he owned more Pillsbury options than any other individual investor in the market. He also purchased a substantial amount of Pillsbury shares. As soon as Grand Metropolitan made its announcement about their impending offer, O'Hagan sold his options and shares, realising a healthy profit.[339] The SEC alleged that O'Hagan had defrauded his employer law firm and its client by using material non-public information about the tender offer 'for his own trading purposes'.[340] O'Hagan was convicted by the trial court. The court of appeal overturned, rejecting the misappropriation theory on which the SEC's case was based, setting the table for a Supreme Court pronouncement on the subject.[341]

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[339] O'Hagan purchased 2 500 call options as well 5 000 shares. He bought the shares for $39 a share and sold them for $60. He realised a total profit, selling both the call options and the shares, of more than $4.3 million. See the Supreme Court's judgment at 647–648.

[340] *O'Hagan* 648.

[341] The case also dealt with the promulgation of Rule 14e-3. This discussion will, however, be limited to the court's reasoning in relation to O'Hagan's misappropriation theory convictions.

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The Supreme Court reversed the judgment of the court of appeal, holding O'Hagan liable for his trading in Pillsbury stock. It expressly held that liability under section 10(b) may be predicated on the misappropriation theory.[342] Carefully distinguishing the two theories, and relying on the reasoning in *Chiarella*, the court held that under the traditional or classical fiduciary duty theory of United States insider trading liability, section 10(b) and Rule 10b-5 are not violated only when a corporate insider trades in the securities of his corporation.[343] It drew the net wider; it held that the classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.[344]

The court defined the misappropriation theory, and its relationship with the fiduciary theory, as follows:

> The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates section 10(b) and rule 10(b)5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. . . . Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between a company insider and a purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.
>
> The two theories are complementary, each addressing efforts to capitalise on non-public information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of non-public information by a corporate outsider in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to protect the integrity of the securities markets against abuses by outsiders to a corporation who have access to confidential information that will affect the

342 *O'Hagan* 650.
343 Ibid. 651–652.
344 Ibid. 652.

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> corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders.[345]

In *Chiarella* it was held that no 'general duty between all participants in market transactions to forgo actions based on material, nonpublic information'[346] existed. A duty arises only from a specific relationship between two parties. The wrongfulness of O'Hagan's conduct was to be found in the breach of the duty of trust and confidence that he owed to his law firm and to its clients. He traded on information about Grand Metropolitan's planned offer for Pillsbury shares.[347] His wrongfulness was not found in the duty he owed to his fellow traders in the share market not to trade with information to which they could not legally have had access.

The court remarked that the misappropriation theory was 'well-tuned' to a purpose of the United States Securities Exchange Act: 'to ensure honest securities markets and thereby promote investor confidence.' It held that:

> Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated non-public information is unchecked by law. An investor's information disadvantage vis-à-vis a misappropriator with material non-public information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill. If the market is thought to be systematically populated with . . . transactors trading on the basis of misappropriated information some investors will refrain from dealing all together, and others will incur costs to avoid dealing with such transactors or corruptly overcome their unerodable informational disadvantage.[348]

It had not been pleaded nor had it been argued that the equal access theory would serve that purpose better. Nor was it explained how holding only certain persons liable for trading on

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[345] Ibid. 652–653.
[346] *Chiarella* 233.
[347] *O'Hagan* 653–654.
[348] *O'Hagan* 659.

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inside information and leaving others (who do not owe a duty to the source nor a duty to the companies' securities in which he is trading), free to trade would promote investor confidence.

2 2 3 5 United States v Carpenter

The insistence on the misappropriation and fiduciary theory has given rise to strange results. There is no better example of this than some of the conclusions reached, although in *obiter dicta*, by the United States Second Circuit in *United States v Carpenter*.[349] Winans and Felis were charged and found guilty under section 10(b) and Rule 10b-5 for misappropriating material, non-public information from *The Wall Street Journal*. Winans was a *Wall Street Journal* reporter. He was one of the writers of a widely read and influential column in the journal, 'Heard on the Street'. Carpenter worked as a news clerk at the journal. Felis was a stockbroker at a brokerage house. Their main defence to the charges against them was that they had not been corporate insiders or quasi-insiders, nor had they misappropriated inside information from insiders or quasi-insiders.[350]

The Dow Jones, the parent company of *The Wall Street Journal*, had a firm policy on possible conflict of interest violations by its employees. It distributed a forty-page manual, with a total of seven pages devoted to conflicts of interest, to all its new employees. Winans and Carpenter were found to have known that the company policy deemed all information learnt by an employee during the course of its employment to be company property and that the company required employees to treat non-public information learnt through their employment as confidential.

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[349] *United Stated v Carpenter* 791 F.2d 1024 (2d Cir. 1986) (*Carpenter*).
[350] Ibid. 1025–1026.

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Winans and his co-conspirators did not heed the prohibitions in the company's policy document. Instead, they provided stockbrokers with securities related information that was scheduled to appear in 'Heard on the Street'. The stockbrokers would use this information to purchase and sell the subject securities. It was common cause that the contents of the column had an influence on the price of securities traded in the market.[351]

The question before the court was could a newspaper reporter, a former newspaper clerk and a stockbroker, not one either a true insider of the company or a tippee of a true insider, be found guilty of trading on inside information? It was clear that Winans had breached a duty of confidentiality to his employer by misappropriating the confidential 'prepublication' information, which he learned in the course of his employment.[352] Did it, however, amount to a contravention of section 10b-5, the United States insider trading section? Winans argued that he could not be held liable under the misappropriation theory as it applied only to insiders and quasi-insiders. He argued that it was not enough that he breached a duty of confidentiality to his employer in misappropriating and trading on material non-public information. According to him, a breach of a duty to the corporation or its shareholders in which he traded would have to be shown.

The court held that United States law prohibits the misappropriation of information not only by insiders, but also by others.[353] It held that liability arose for the mere fact that one misappropriates non-public information and trades on that information to his advantage. The rule was not purely aimed at trading on inside information by corporate insiders.[354] The court

[351] Ibid. 1027.
[352] Ibid. 1028.
[353] Ibid. 1029.
[354] Ibid.

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referred with approval to 'the commonsensical view that trading on the basis of improperly obtained information undermined the prophylactic intent of the securities laws'.[355]

The court held that an employee's unlawful misappropriation from an employer of material non-public information was indeed prohibited by section 10(b) and Rule 10b-5. It found further that Winans and his conspirators were liable for 'secreting, stealing, purloining or otherwise misappropriating material non-public information in breach of an employer-imposed fiduciary duty of confidentiality'.[356] Still, it was willing to accept that if it were Winans's employers trading, they would not have been held liable. It wrote as follows:

> Appellants argue that it is anomalous to hold an employee liable for acts that his employer could lawfully commit. Admittedly, . . . [the] *Wall Street Journal* or its parent, Dow Jones Company, might perhaps lawfully disregard its own confidentiality policy by trading in the stock of companies to be discussed in forthcoming articles. . . . Although the employer may perhaps wilfully destroy its own reputation, its employees should be and are barred from destroying their employer's reputation by misappropriating their employer's informational property. . . . Here, appellants, constrained by the employer's confidentiality policy, could not lawfully trade by fraudulently violating that policy even if the journal, the employer imposing the policy, might not be said to defraud itself should it make its own trades.[357]

To be sure, *Carpenter* was decided in 1986. However, it is accepted that nothing said there is at odds with the current-day leading decision of *O'Hagan*.[358] The misappropriation theory prohibits undisclosed trading in breach of a duty of loyalty to a principal; it does not prohibit the principal from trading on the same information.

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[355] Ibid., referring to what was said in *SEC v Musella* 578 F Supp 425 (SDNY 1984) 438.
[356] *Carpenter* 1031.
[357] Ibid. 1033–1034.
[358] Bainbridge (2010) *J Corp L* 2010.

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2 2 3 6 Dirks v SEC[359]

United States insider trading law, like South African insider trading law, recognises the concept of tipper and tippee liability, which I discuss in more depth in the insider chapter.[360] A tippee is a person who receives inside information from a tipper. A tipper is a person who passes on inside information. The main tippee liability case in the United States is *Dirks v SEC*.[361] There the Supreme Court of the United States held that the mere receipt of confidential information from an insider does not impose a disclose or abstain duty on the recipient of the information. A tippee can be held liable only if he knowingly collaborates with a tipper in breach of a duty. The tippee's liability depends on a breach of duty by the tipper. The reasoning in *Dirks* is testament to the theoretical difficulties courts run into when they are confronted with applying a fiduciary or misappropriation duty-based theory to insider trading regulation.

Dirks was an officer of a New York broker-dealer firm who specialised in providing investment analysis of insurance company securities to institutional investors.[362] He received information from one Secrist, a former officer of Equity Funding America. Secrist told Dirks that Equity Funding's assets were substantially overvalued as a result of corporate

359 463 US 646 (1983) (*Dirks*).
360 See p. 275 et seq. below.
361 Ibid. For discussions of this judgment see B A Hiler "Dirks v SEC – A Study in Cause and Effect" (1984) 43 *Md L Rev* 22; H Heller "Chiarella, SEC rule 14e-3 and Dirks: Fairness v economic theory" (1981) 37 *Bus Law* 517; D R Fischel "Insider Trading and Investment Analysts: An Economic Analysis of Dirks v Securities and Exchange Commission" (1984) 13 *Hofstra L Rev* 127; M A Tripp "Access, Efficiency, and Fairness in Dirks v SEC" (1984) 60 *Ind LJ* 535; G Wang "Dirks v Securities and Exchange Commission: An Outsider's Guide to Insider Trading Liability under Rule 10b-5" (1985) 22 *Am Bus L J* 569; H Harp "Outsider Trading after Dirks v SEC" (1983) 18 *Ga L Rev* 593; M Farley "A Current Look at the Law of Insider Trading" (1983) 39 *Bus Law* 1771; G R Andre "Constructive Insider Liability and the Arm's Length Transaction under Footnote 14 of Dirks" (1983) 52 *Geo Wash L Rev* 872; R E Ratliff "Securities: Dirks v SEC – When insiders talk, should you listen" (1984) 37 *Okla L Rev* 194; and K Donelli "Dirks v SEC: New Guidelines for Tippee Liability under Rule 10b-54" (1983) 4 *Pace L Rev* 631.
362 The facts are stated here as they were accepted and recorded in the judgment of the Supreme Court of the United States.

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malpractices, and urged him to look into the matter. Dirks investigated the allegations. He visited Equity Funding's headquarters in Los Angeles and interviewed several officers and employees of the corporation. Equity Funding's senior management denied any wrongdoing, but some of its employees corroborated the charges of fraud. Neither Dirks nor his firm owned any Equity Funding shares. Throughout his investigation he openly discussed the information he had obtained with a number of clients and investors. Some of these persons, including five investment advisers, sold more than $16 million worth of Equity Funding's shares.

While Dirks was busy with the investigation he also contacted *The Wall Street Journal*, urging them to write a story on the Equity Funding fraud. The journal declined for fear that the publication might be libellous. That notwithstanding, in the two-week period Dirks was busy with his investigation, and spreading word of the fraud, Equity Funding's share price nearly halved. This led to the New York Stock Exchange halting trading in its stock and the California insurance authorities impounding Equity Funding's financial and other records. Widespread evidence of the fraud was found. The SEC filed a complaint against Equity Funding and *The Wall Street Journal* published a front-page story based to a large degree on the information assembled by Dirks.

The SEC also began an investigation against Dirks. He was found guilty of aiding and abetting the contravention of section 10(b) and SEC Rule 10b-5 by repeating the allegations of fraud to members of the investment community, who consequently sold their Equity Funding stock. The SEC concluded:

> Where "tippees" – regardless of their motivation or occupation – come into possession of material corporate information that they know is confidential and know or should know that it came from a corporate insider, they must either publicly disclose that information or refrain from trading.[363]

[363] As quoted in *Dirks* par 651.

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Dirks appealed to the District Court of Columbia, but lost. The United States Supreme Court granted *certiorari* 'in view of the importance to the SEC and to the securities industry' of the question presented by the case.[364] The court referred to *Chiarella* and its insistence on the requirement of a specific relationship between a buyer and a seller of shares before a duty to disclose is established. It wrote:

> This requirement of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and the courts in policing tippees who trade on inside information. Unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationship. In view of this absence, it has been unclear how a tippee acquires the *Cady, Roberts* duty to refrain from trading on inside information.'

The court set out to clarify on what basis a tippee could be held liable. The SEC had argued that Dirks was liable as he breached a duty, which he had assumed as a result of knowingly receiving confidential information from insiders. Tippees such as Dirks, so the SECs argument went, who knowingly received non-public material information from true insiders, became subject to the same duty as the insiders from whom the information had been received. It argued further that to establish a rule that insider-trading liability exists only when information is transmitted for an improper purpose, would enable the parties easily to fabricate some legitimate business justification for transmitting inside information.

The court held that the SEC's theory of tippee liability appeared to be rooted in the idea that United States financial market law requires equal information among traders. The majority of the court,[365] as in *Chiarella*, rejected this theory by holding that a duty to disclose arose only from a specific relationship between the two trading parties and not merely from the one party's ability to acquire information because of his position in the market.[366] Coming to the

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[364] *Dirks* 652.
[365] The majority judgment was written by Justice Powell.
[366] *Dirks* 658.

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conclusion that the recipients of inside information do not invariably acquire a duty to disclose or abstain, the court held that:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material non-public information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which … is necessary to the preservation of a healthy market. It is commonplace that analysts [gather and analyse information] … and this often is done by meeting with and questioning corporate officers. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be simultaneously available to all of the corporation's stockholders or the public generally.[367]

The court did hold that there was a need to ban some tippee trading. About tippers, it reasoned that not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but also they may not give such information to outsiders for the same improper purpose of exploiting the information for their personal gain. This is so, held the court, as a contrary rule 'would open up opportunities for devious dealings in the name of others that the trustee could not conduct on his own'.[368] The tipper represents only one side of the wrong. Thus, reasoned the court, certain tippees must be held to be subject to the insider's duty to shareholders. This is so not because of the mere fact that they receive inside information, but because the information is made available to them improperly.[369] Accordingly, held the court:

> a tippee assumes a fiduciary duty to shareholders of a corporation not to trade on material non-public information *only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach*. . . . Tipping is thus properly viewed only as a means of *indirectly* violating the *Cady, Roberts* disclose-or-abstain rule. [370] (Emphasis added.)

[367] Ibid. 659.
[368] Ibid. 659.
[369] Ibid. 660.
[370] Ibid. 661.

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The court held further that in determining whether a tippee is under an obligation to disclose or abstain, it is necessary to determine whether the insider's tip constituted a breach of his fiduciary duty. All disclosures made by insiders of material, non-public information would therefore not be contrary to the fiduciary duty owed by the insider. It held further that whether disclosure is made in breach of a duty will depend, to a large extent, on the 'purpose of the disclosure'.[371] So, absent a breach by an insider, there is no derivative breach.[372] The tippee could not, in other words, be held guilty of knowingly trading on inside information, committing a wrong merely as a market participant against other market participants, without more.

The court held that to determine whether the disclosure itself deceives, manipulates or defrauds shareholders, the initial inquiry is whether there has been a breach of duty by the insider.[373] To establish whether a breach occurred requires the assessment of objective criteria such as whether the insider receives a benefit, whether it be directly or indirectly, from the disclosure. This benefit, according to the court, could for example be for pecuniary gain or a 'reputational benefit' that will lead to future earnings.[374] The court held that there would be objective facts and circumstances that often justify such an inference. What is more, held the court, the 'elements of fiduciary duty and exploitation of non-public information' are also present where an insider makes a gift of confidential information to a relative or a friend.[375]

In Dirks's case, the court found there had been no actionable violation. It found that Dirks was a stranger to Equity Funding and, as such, had no pre-existing duty to its shareholders.

[371] Ibid. 663.
[372] For support for its reasoning, the court cited *In re Investors Management Co* 44 SEC 633 (1971) 648 where the commission held that: 'It is important in this type of case to focus on policing insiders and what they do ... rather than on policing information *per se* and its possession.'
[373] *Dirks* 663. See on this point also V Brudney "Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws" (1979) 93 *Harv L Rev* 322 348. The author writes that '[t]he theory . . . is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself'.
[374] *Dirks* 663.
[375] Ibid. 664.

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Dirks had taken no action, either directly or indirectly, that induced the company's shareholders or officers to found trust or confidence in him. Furthermore, the court found that neither Secrist nor any other Equity Funding employee violated a duty to the corporation's shareholders. The tippers had not received any monetary or personal benefit for revealing Equity Funding's secrets, nor did they make a gift of the information to Dirks. The court found that Dirks had no duty to abstain from the use of the inside information he had obtained and reversed the decision of the Court of Appeal.

Justice Blackmun again wrote a minority judgment in which two other members of the court, Justice Brennan and Justice Marshall, concurred. Justice Blackmun saw the majority's reasoning as placing yet another limit[376] on the protections provided to investors under the United States section 10(b). The majority incorporated a special motivational requirement into the fiduciary duty doctrine, which was not justified. It excused the knowing and intentional violation of an insider's duty to shareholders where the insider does not act for personal gain.[377]

The minority placed particular emphasis on the fact that Dirks chose to whom to disseminate information, selectively disclosing the information to only a few people. One of Dirks's first actions on becoming aware of Equity Funding's troubles was to direct his associates at his firm to draw up a list of all their clients who were invested in Equity Funding. As he gathered further information, he disclosed it to these clients. The minority found that Dirks's attempts to disclose information to non-clients were 'feeble, at best'. They reasoned that:

> The effect of Dirks' selective dissemination of Secrist's information was that Dirks' clients were able to shift the losses that were inevitable due to the Equity Funding fraud from themselves to uninformed market participants. … Dirks [disseminated] information to [his] clients, who in turn dumped stock on unknowing purchasers.[378]

[376] See the dissenting opinion in *Chiarella*.
[377] *Dirks* 669.
[378] *Dirks* 669–670.

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The loss was shifted from those in the know to those not lucky enough to be connected.

Justice Blackman concluded by finding that Secrist violated his duty to Equity Funding's shareholders by communicating the material, non-public information to Dirks with the intention that Dirks would cause his clients to trade on that information. The Court held that Dirks was under a duty to make the information publicly available or to refrain from actions that he knew would lead to trading. As he caused his clients to trade, he fell foul of section 10(b) and Rule 10(b-5). 'Any other result,' said Justice Blackman, 'is a disservice to [the United States'] attempt to provide fair and efficient capital markets'.[379]

In the end, however, the majority of the court, albeit in the realm of tippee liability, reaffirmed *Chiarella*'s recognition of the classic insider trading theory as the basis for insider trading regulation in the United States. The court did recognise an extension of insider trading liability: the liability of tippees; temporary insiders; and sellers of securities, along with the buyers. But tippees, it was held, could be liable only under a theory of derivative liability; only if it were to be found that the tipper breached his fiduciary duty to the company, would the tippee be held liable for his trading.[380] In this way, the court also extended the fiduciary duty owed to 'temporary insiders', creating two groups of insiders: permanent or proper insiders, such as directors and managers;[381] and temporary insiders, such as underwriters, accountants, lawyers or consultants working for the corporation.[382] Temporary insiders, according to the court, are held liable:

> not simply [because] such persons acquired non-public corporate information, but rather [because] they have entered into a special relationship in the conduct of the

[379] Ibid. 679.
[380] Ibid. 659–60. Also see M G Dworkin "Misappropriation Theory as a Corollary to the Classic Insider Trading Theory" (1996) 1996 *Ann Surv Am L* 315 327.
[381] *Dirks* 655.
[382] *Dirks* 655 footnote 14.

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> business of the enterprise and are given access to information solely for corporate purposes.[383]

In other words, their liability has nothing to do with a duty between the sellers and purchasers in the market as between each other.

2 2 3 7 United States v Chestman

In *United States v Chestman*,[384] the relevant duty had to be found in familial relationships. Chestman was a stockbroker. Keith Loeb was a client of Chestman. Chestman had previously assisted Loeb and his wife to consolidate their holdings in Waldbaum Inc (Waldbaum's). In the course of the transaction Loeb told Chestman that Loeb's wife was the granddaughter of Julia Waldbaum, a member of the board of directors of Waldbaum's and the wife of its founder. Julia Waldbaum was also the mother of Ira Waldbaum, the president and controlling shareholder of Waldbaum's. For four years Chestman executed several transactions involving Waldbaum's for Loeb.[385]

Then Ira Waldbaum agreed to sell the company. The resulting stock purchase agreement required him to tender a controlling block of Waldbaum's shares to the buyer at a specified price. Ira Waldbaum told his children and all Waldbaum's employees, of the pending sale two days after concluding the agreement, at the same time admonishing them to keep the news quiet until the public announcement. Ira Waldbaum also told his sister, Witkin, and a nephew, Karin, and offered to tender their shares along with his controlling block to enable them to

[383] Ibid.
[384] 947 F 2d 551 (2d Cir 1991).
[385] Ibid. 555.

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avoid the difficulties of tendering after the public announcement.[386] He specifically cautioned them that the sale was to remain confidential.

Witkin, however, told her daughter, Susan Loeb. Witkin warned Susan not to tell anyone except her husband, Keith Loeb. Susan told Keith, warning him not to tell anyone else. Keith duly phoned Chestman, telling him that Waldbaum's was about to be sold at a price substantially higher than market value. Chestman, in turn, executed several purchases of Waldbaum's shares. Not only did he buy for his clients, including Loeb, he also bought shares for himself.[387] Loeb turned state witness.

To found Chestman's liability Loeb would have had to be a misappropriator. The prosecution argued that Loeb breached a fiduciary duty to his wife, Susan, and the Waldbaum family when he disclosed to Chestman information about the pending tender offer.[388] The court acknowledged that the relationships involved in the case, those between Keith and Susan Loeb and between Keith Loeb and the Waldbaum family, were not that of traditional fiduciary relationships.[389] It then discussed the misappropriation theory's requirement of a 'similar relationship of trust and confidence'.[390] The court held that,

> the repeated disclosure of business secrets between family members may substitute for a factual finding of dependence and influence and thereby sustain a finding of the functional equivalent of a fiduciary relationship.[391]

It found that there was insufficient evidence to establish a fiduciary relationship or its functional equivalent between Keith Loeb and the Waldbaum family or between Keith and

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386 Ibid.
387 Ibid.
388 Ibid. 570.
389 Ibid. 568.
390 Ibid.
391 Ibid. 569.

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Susan.[392] Because Keith owed neither Susan nor the Waldbaum family a fiduciary or some sort of equivalent duty, he was not guilty of a Rule 10b-5 contravention by disclosing the tender offer news to Chestman. Absent the duty, held the court, Chestman could not be derivatively liable as Loeb's tippee.[393]

2 2 3 8 SEC v Cherif

A rather tenuous link between the source of the information and the purported breach was found in *SEC v Cherif*.[394] In *Cherif* the United States Seventh Circuit had to found misappropriation liability in a situation where the employment relationship of the insider had ended. To this end the court held that even though the employment relationship ends, the duty to the source of the information, the employer, does not. The misappropriation theory's reach was extended to a former employee who had kept his access card and was so able to steal business related information. Cherif was employed in the international financial institutions department of First National Bank of Chicago for almost ten years.[395] He was retrenched. When his employment ended, Cherif kept his access card and managed to keep it activated through fraudulent means. He was able to access the bank's building freely in the late evenings and on weekends. His main focus within the bank was the specialised finance department, which contained information about proposed takeovers and leveraged buyouts.[396] A comparison of the bank's security records and Cherif's trading activity revealed that he had been trading in four company's shares about which the specialised finance department held

[392] Ibid. 570.
[393] Ibid. 571.
[394] 933 F 2d 403 (7th Cir 1991) (*Cherif*).
[395] They facts are stated here as they were found and recorded in the judgment of the court of the United States Seventh Circuit.
[396] A leveraged buyout occurs when an investor, typically a financial sponsor, acquires a controlling interest in a company's equity, while a significant percentage of the purchase price is financed through leverage (borrowing). The assets of the acquired company are used as security for the borrowed capital, at times together with the assets of the acquiring company. Typically, a leveraged buyout uses a combination of various debt instruments from bank and debt securities.

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information. The factual evidence, comparing the timing of his trades with information in the department, was undeniable:[397] Cherif was knowingly trading with inside information.

If conduct such as that of Cherif were to be allowed in a securities market, the integrity of the market would surely suffer. However, more is to be established in a jurisdiction wherein some duty is to be breached (or indeed where there is a closed definition of 'insiders') before liability for trading on inside information could be found. As Cherif was trading in such a jurisdiction, he argued that he could not be held liable on the basis that he could not properly be branded a misappropriator. He argued that the SEC wrongly relied on the misappropriation theory to found his conviction. Among other things, he argued that the theory did not hold him liable as his employment relationship with the bank had ended prior to his trades and he therefore owed no duty to the bank.

The bank had required all its employees to sign an 'integrity policy' restricting the use and disclosure of what the policy termed 'material inside information' for personal gain. The policy furthermore warned employees that the improper use of inside information could result in criminal and civil penalties. Cherif had signed this agreement on numerous occasions, but it was binding only for as long as Cherif was employed. He accepted that he may have stolen information and traded on inside information, but denied, as it was open to him to do, that he was guilty of insider trading. Notwithstanding the fact that the contractual link between Cherif and the bank contained in the bank's integrity policy had ended, the court found that Cherif was bound by a 'broader common law duty'.[398] It found this duty in the United States law of agency, which obligated an employee to protect confidential information entrusted to him

[397] Also see the court's findings on this point at page 412–413 of the judgment.
[398] *Cherif* 411.

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during his employment, and after it comes to an end.[399] The rule had been developed to prevent former employees from divulging trade secrets.

The court found that Cherif had breached a 'continuing duty' to his former employer when he used the key card and obtained confidential information. It held that it made no difference that he stole the information only after his employment had ended. The information he had obtained while still in the bank's employ enabled him to carry out his thefts successfully.[400] Cherif 'used property and information belonging to First Chicago, and made available to him only through his fiduciary relationship, against the bank's own interest'.[401]

Cherif is a good example of the awkwardness of the misappropriation theory. It may be considered to have given rise to an equitable outcome, but the misappropriation theory did not fit the cause. As Langevoort points out, in an instance where it could not be shown that the employee conceived of the idea to steal the information while he owed a duty to the source of the information, it simply does not explain the trader's liability.[402]

2 2 3 9 SEC v Falbo

In *SEC v Falbo*[403] the court found a secretary to a key executive and her husband, an electrician hired by the company to work on its security system, to be liable for their insider trading. In relation to the husband, the court emphasised that he had been in a position of trust and confidence, noting especially that he had been given a master key and had been given access to the company's executives' offices. The *Falbo* litigation arose out of Grand Metropolitan's

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[399] Ibid.
[400] Ibid.
[401] Ibid.
[402] *Langevoort on insider trading* (Rel 7 4/2009) 6–19 note 4.
[403] 14 F Supp 2d 508 (SDNY 1998) (*Falbo*).

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takeover bid for all the outstanding shares of The Pillsbury Company. Following the announcement of the offer, Pillsbury's share price rose by more than 40%.

Theresa Falbo worked as a secretary for Grand Met's senior executive vice president at the company's head office. She fulfilled general secretarial duties, but was included in a team of employees specifically working on the Pillsbury tender. Her husband, Robert, was an electrician by trade who worked for himself. He did work for Grand Met both directly and as a subcontractor. He was responsible for the installation of a key-card system limiting access to the third floor of Grand Met's building. The installation was specifically aimed at separating Grand Met's employees working on the Pillsbury offer, from those employees who were not. Robert retained a master key to access the third floor.

Grand Met employed various means to keep their plans of making the offer secret. They used code names in referring to themselves and the target company; they installed shredders on the cordoned off third floor to ensure that documents relating to the offer were destroyed rather than leaked; they limited access to the floor through the access cards; and the few people allowed access to the knowledge of the offer were instructed not to divulge any information relating to it, especially to their family members. Grand Met was not very successful in keeping their plans secret. Among other instances indicating leaks, news channel CNN's programme Money Line commented that there were rumours of a takeover by Grand Met, and leading businessmen were seen making purchases of Pillsbury stock prior to the takeover.

So did Robert Falbo. Indeed, he made large purchases, bigger than any securities purchases he had made in his life, of Pillsbury stock just prior to the takeover. The SEC claimed that Falbo, and his co-defendant, was liable under the misappropriation theory. There was no doubt that Falbo had been in possession of inside information before his trades. For it was found that he had eavesdropped on Grand Met's executives while he worked on renovations and that he received information from his wife. They had watched Money Line together, which led

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Falbo to question his wife and get the information he needed. But did he owe a duty to the source of his inside information? The court found that Falbo, apart from his liability as tippee as a result of the information received from his wife, also had an independent duty not to reveal or trade with the information he had obtained during the course of his work with Grand Met.

The court found that, as he was a contractor handling the electrical work of the renovations intended to prevent leaks of information concerning the planned tender offer for Pillsbury shares, he could still be held liable under the misappropriation theory.[404] The court reiterated what was held in *Chestman* that to found liability under the misappropriation theory, the test is not whether there had been a fiduciary relationship, but whether there existed a 'similar relationship of trust and confidence . . . which must be the equivalent of a fiduciary relationship'.[405]

The court held that the duty required to found liability in terms of the misappropriation theory in United States law, is as follows:

> A fiduciary relationship involves discretionary authority and dependency. One person depends on another – the fiduciary – to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relationship may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use. What has been said of an agent's duty of confidentiality applies with equal force to other fiduciary relations: an agent is subject to a duty to the principal not to use or to communicate information confidentially given to him by the principal or acquired by him during the course of or on account of his agency. These characteristics represent the measure of the paradigmatic fiduciary relationship. A similar relationship of trust and confidence consequently must share these qualities.[406]

[404] Ibid. 523.
[405] Ibid.
[406] Ibid. and *Chestman* 569.

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The court found that Grand Met had placed Falbo in a position of trust and confidence.[407] It emphasised the fact that Falbo had been handed a key specially to have access to certain restricted areas. Falbo abused his position for personal benefit and for that, was held guilty of insider trading.[408]

2 2 3 10 SEC v Willis

In *SEC v Willis*[409] the liability for a financial market wrong was found in the breach of a psychiatrist's duty of confidentiality owed to his patient. One Weill conceived of a plan to become the Chief Executive Officer of BankAmerica. He had served as the CEO of a number of companies and had been the president of American Express. As part of his quest to become BankAmerica's CEO, he secured a commitment from one of his previous companies to invest $1 billion in the bank if he were successful in his negotiations.

Weill met with several of BankAmerica's directors to discuss his proposals. The information relating to these meetings was strictly kept out of the public domain. At that point the perception of BankAmerica's shares in the market was largely unfavourable. Among other things, Moody's Investors' Service had downgraded billions of dollars of debt owed by BankAmerica, and it had posted large quarterly and yearly losses. Eventually Weill's endeavours came to nought. BankAmerica made a public announcement that he had offered to become its CEO, but that they were not interested in his offer.

In the meantime, Weill had been discussing his efforts to become the bank's CEO with his wife. She was a patient of a psychiatrist, Dr Willis. She discussed her husband's efforts to become the bank's CEO with Dr Willis, prior to the public announcements of Weill's interest

[407] *Falbo* 523.
[408] Ibid.
[409] 737 F. Supp 269 (SDNY 1990).

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in the bank. She also disclosed the commitment her husband had secured from one of his previous companies to make the large investment in BankAmerica when he became its CEO. Dr Willis in turn disclosed this information to his broker. The broker purchased large numbers of shares in BankAmerica for him and his children.

The SEC charged Willis with insider trading in terms of the misappropriation theory. The charges were based on his breach of a 'physician's traditional duty of confidentiality on which his patient was entitled to rely when he misappropriated for his personal profit [inside information] confided to him by his patient for her psychiatric diagnosis and treatment.[410] The court reasons, it is to be remembered, in the field of financial market law. Specifically, it deals with a wrong that is committed when one informed trader trades with an uninformed trader. Cederbaum DJ proceeded as follows:

> Central to the sufficiency of the indictment, and central to the misappropriation theory of securities fraud, is a breach of fiduciary duty or similar duty of trust and confidence. It is difficult to imagine a relationship that requires a higher degree of trust and confidence than the traditional relationship of physician and patient. The "oath" of Hippocrates, which has guided the practice of medicine for more than 2000 years, concludes with the following words:
> "Whatsoever things I see or hear concerning the life of men, in my attendance on the sick or even part therefrom, which ought not be noised abroad, I will keep in silence thereon, counting such things to be as sacred secrets."[411]

In this way, a breach of the Hippocratic Oath found liability for a financial market wrong.

[410] Ibid. 272.
[411] Ibid.

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2 2 4 Conclusion

The fiduciary duty doctrine and misappropriation theory as theories of regulation of insider trading are based on premises related to companies and their inner workings. They are born out of, in the case of the fiduciary doctrine, the divide between ownership and control and, in the case of the misappropriation theory, some other duty owed to the source of the information. Having fair financial markets and increasing confidence in the South African financial markets as the focus of financial market law, is to recognise that a breach of duty removed from relationships in those markets should not be the primary focus of regulating trading on inside information. The regulation should rather focus on the regulation of the unfair use of inside information between market participants.[412] For if this is not done, the legislature ends up criminalising employee work rules and the breaches of duties of trust, completely unrelated to the functioning of the market, while proclaiming its object to be market related.[413]

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[412] See D L Block & N E Barton "Securities Litigation: Insider Trading – The Need for Legislation" (1983) 10 *Sec Reg LJ* 350 371 who make the same argument in a different setting in the United States in the early 1980s.

[413] See Beesom (1995) *U Pa L Rev* 1142.

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2 3 Market theories of regulation

A move from the fiduciary doctrine and the misappropriation theory to a market theory of regulation includes a shift in paradigm. The move requires recognition that, in actual fact, the principle that requires the prohibition of insider trading, requires the protection of the public against all who have an unfair information advantage.[414] Any financial market-related theory of prohibition will view the wrong committed through trading on inside information as one committed by one trader against another, whatever the identity of either the traders to a trade might be. In this lies a distinction between a market theory of insider trading, and the fiduciary duty doctrine and misappropriation theory. A market theory does not primarily deal with shareholders and managers; it deals with traders *inter se*. Different from the fiduciary duty doctrine and the misappropriation theory, a market theory of regulation does not require a connection between the person with knowledge of inside information and the company whose securities are the subject of the information. The Supreme Court of Western Australia has summed up its views on a market rationale for the regulation of insider trading as follows:

> According to the market fairness rationale, a person in possession of confidential price-sensitive information should not be permitted to trade in securities of the corporation in question until the information has been publicly disclosed. This prohibition should apply irrespective of the source of the information which the person possesses and irrespective of the presence or absence of any connection or association between the person and the relevant corporation.[415]

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[414] See Brudney (1979) *Harv L Rev* 360. Brudney argued for an equal access to information approach in the United States under its general, broad anti-fraud provision.

[415] *R v Mansfield* 2011 WASCA 132 par. 53. Also see the *Australian Companies and Securities Advisory Committee's Insider Trading Discussion Paper* (June 2001) par. 1.20 to 1.21 where the notion of market fairness was dealt with as follows:

> All market participants bear trading and other risks in their market dealings. These risks include that other participants have better skills to analyze the market, have access to better market research or respond more quickly to information as it comes into the public domain. Market participants with superior skill, time or commitment will therefore inevitably have a trading advantage.
>
> Market fairness does not require elimination of these risks or advantages. Likewise, market participants should not be discouraged from conducting research and analysis, which promote the efficiency of these markets. Indeed, skill, acumen and diligence should be encouraged. However,

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Adopting this approach has consequences. Firstly, the requirement that, for insider trading liability to follow, there must be a fiduciary or fiduciary-like duty owed and breached, falls by the wayside. The duty a court would look to is a duty owed to the market place as a whole, including each of its participants. The recognition of that duty would establish the agreement, in the form of a societal compact, that Pufendorf declared would keep the first merchant from selling his wheat at the price at which he pleased. This also means that the requirement, of a fiduciary or fiduciary-like duty owed and breached, no longer places a limit on the scope of a prohibition. That consideration and the fear of some sort of limitless liability have weighed heavily with the United States courts in their constant rejection of a market-based theory for the regulation of insider trading.[416] The United States courts' approach is, however, not justifiable, and the fears should not be an impediment to the required paradigm shift. It is not unknown in law for duties to be owed to wide categories of people.[417] For instance, at the extreme, in criminal law, a duty is owed to society as a whole.[418] A duty owed to the marketplace as a whole is akin to that kind of duty.[419] Where these duties are recognised, liability is limited by concepts such as foreseeability[420] and by requirements in respect of the knowledge of a trader at the time of her trade. Secondly, as a consequence of leaving the fiduciary duty doctrine and the misappropriation theory behind, the considerations relevant to the formulation of a regulatory scheme are limited to those which are market related. A legislature will exclusively have regard to the functions and characteristics of the financial markets in developing its regulatory scheme and in giving content to notions such as fairness and public confidence in the financial markets.

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insider trading deals with situations where market participants, who hold confidential price-sensitive information, can take the premium from trading without the same risks that are run by other market participants, who cannot gain access to that information by ordinary research, skill or analysis.

416 Branson (1981) *Emory LJ* 280.

417 Ibid.

418 Ibid.

419 Ibid.

420 Ibid.

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One of the financial system's primary functions is the efficient channelling of resources from savers to borrowers.[421] Through that function, the financial markets ensure that funding goes to firms based on the prospects of success of their proposed future endeavours.[422] The financial system facilitates production, employment and consumption, as it ensures that financing is sown where it will produce the greatest harvest for an economy as a whole. An economy's financial development is thus linked to its economic growth.[423]

Public confidence, when seen in the light of market-related considerations, is determined by recognising at least one fundamental premise and is influenced by at least one important factor. The fundamental premise is that information is the basis upon which rational economic actors (the ones, I would suggest, the legislature should be concerned with) make their investment decisions.[424] The important factor is public perception.

For the public to have confidence in the financial markets it has to perceive, firstly, the current quotations of share value to accurately reflect the value of an investment or a prospective investment.[425] In other words, the investor knows that she will not be paying R10 for something worth R5, or selling something worth R10 for R5. The financial markets, it is accepted, create a platform upon which the prices of securities are determined.[426] The prices

421 Ibid. 329.
422 Ibid.
423 Ibid.
424 Cecchetti *Money, Banking and Financial Markets* 6.
425 Loss (1970) *Mod L Rev* 84 86.
426 Indeed, markets form the core of the financial system. Markets are where buyers and sellers meet, where firms issue their stocks and bonds, and where individuals and firms go to purchase assets. Economic theory heralds financial markets as essential to any economy, charging them with the fundamental role of channelling the resources in an economy and minimizing the cost of both the gathering of information and transacting. It is accepted that well-developed financial markets is a precondition for healthy economic growth. (Cecchetti *Money, Banking and Financial Markets* 6).

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of securities in turn summarise[427] and convey information[428] about an issuer, eliminating much of the time a prospective investor would have spent collecting information. The information prices convey is of obvious importance to an investor. She has to be able to use prices in her assessment of the bargain that she is striking. On the other hand, as high stock prices indicate value, firms with high stock prices easily procure the financing they require with future issues.[429] The price at which securities are traded reflects, to the issuing firm, the investing public's willingness to take them up. The higher the prices, the more likely the firm in question will be to go directly to the financial markets to obtain financing.[430] Secondly, the public has to perceive the playing field the financial markets presents as relatively level.

Notably, confidence in the financial markets relates to confidence in the markets and the relationships in those markets. It does not relate to the inner workings of companies and the duties owed by directors or others who owe duties to the source of the inside information.[431] The public's confidence in the financial markets does not depend on whether those trading with inside information are fiduciaries or missapropriators; it does not depend on the presence or absence of some formal historically recognised legal connection between the insider and

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427 Cecchetti *Money, Banking and Financial Markets* 43. The perceived value of a firm, and its securities, can be influence by many factors. See G J De Bondt "Determinants of Stock Prices: New International Evidence" (2008) 34 *J of Portfolio Management* 81. Among the most important determinants are a security's earnings potential, a risk-free income stream and long-run equity risk (the difference between the rate of return in the prospective security and the return on government securities). Any information relating to these variables will influence the stock price. In the short run stock prices can be influenced by exchange rates, commodity prices, momentum (where investors buy stocks that were past winners while selling the losers (investors following the 'trend is your friend mantra'), and seasonality (illustrated by the market saying 'sell in May and go away, but remember to come back in September').

428 R Zeckhauser & V Niederhoffer "The performance of market index futures contracts" (1983) 39 *Fin An Journal* 59. The investor is particularly interested in the characteristics of an instrument that are likely to influence its future value, such as the size of the payment that is promised or the realisation of the price in the case of equity; when the promised payment is to be made; the likelihood that it will be made; and the circumstances under which the payment is to be made. (Cecchetti *Money, Banking and Financial Markets* 45).

429 Cecchetti *Money, Banking and Financial Markets* 189.

430 Ibid. 6.

431 This is based on the premise that one element in the definition of inside information would address access to information.

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the company whose shares are the subject of the trade. Nor should that connection play any role when it comes to giving content to fairness in a market setting. That content should be determined with reference to information. Information which has not yet been reflected in a security's price is of especial importance. It provides the means to predict movements in prices. For if the true value of a security is not reflected in its price and requires a rise or fall in that price, knowing the information, which is not yet reflected in the share price, will allow an investor to predict a future price movement.

It could be argued, of course, that the information disparities in the financial markets are inevitable, no matter what regulation is sought to be employed. It is true, every securities trader runs the risk that, just after she has traded, some good or bad news will come to light, which could detrimentally affect the investment she has just made or which shows that she should not have sold the one she had.[432] That is the normal risk run. No legislature can relieve market participants of that burden. There will always be uncertainties and risks in the market for corporate securities. In financial terms this risk justifies the reward investors obtain.[433] Risk and unpredictability are part of investing in a regulated market.

This, however, takes the matter no further. If the same line of reasoning were to be employed in relation to murder, society would have to stop prosecuting murderers. It is uncontentious to say that murder in a human society is, much like trading on inside information it seems, inevitable. That does not mean that society, through its laws, should not strive for an ideal wherein people do not murder each other. If information disparity in the financial markets is inevitable, this does not mean that society, through its laws, must not strive for an ideal in respect of information disparities. The theory presents the ideal to be strived for; the legislative measures employed provide the means by which that ideal is pursued. Two main ideals for

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[432] L C B Gower & P L Davies *Gower & Davies Principles of Modern Company Law* 7 ed (2003) 751.
[433] Rider & French *The Regulation of Insider Trading* 2.

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equality of information are as follows: parity of information between traders and equal access to information by traders.

2 3 1 The parity of information theory

The parity of information theory requires two parties to a securities transaction to have the same information. Only then would the trade be legal. It does not take much consideration to realise that the theory is an unrealistic one. It proposes a principle that would be detrimental to the financial markets in three ways.

Firstly, a parity of information basis for the regulation of insider trading would raise transaction costs in the financial markets to an unacceptable degree. If the theory were to be employed, transaction costs would rise beyond the point at which trade would be viable. For parties would forever be busy trying to ensure that their counterparty has exactly the same information as they do. Secondly, it would reduce incentives to trade to an unacceptable degree. Thirdly, it would destroy the incentive of market participants to engage in research. Market professionals would be obliged to disclose any information advantage, no matter how it was obtained, whether through research and experience or otherwise, to their counterparty to render the securities transaction lawful. They would no longer ferret out information and this would have a negative effect on the price signalling function fulfilled by the financial markets.

Insider trading regulation must find a balance between some level of equality of information for all investors and allowing market professionals (or anyone else) the opportunity to trade on information that they obtain through market research.[434] The parity of information theory

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[434] R S Karmel "The Relationship between Mandatory Disclosure and Prohibitions against Insider Trading: Why a Property Rights Theory of Insider Information is Untenable" (1993–1994) 59 *Brook L Rev* 149 156.

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does not strike the right balance. It gives too much scope to the equality consideration. It has therefore correctly been described as a theory that strives for an 'egalitarian utopia'.[435] One might add a 'practically unworkable' egalitarian utopia. It would unreasonably restrict trade in securities.

2 3 2 Equal access to information

The equal access to information theory asserts that market participants should have equal access to information relevant to their security trading decisions. According to this theory, the unfairness in insider trading does not lie in not having as much information as one's counterparty, but rather in the inability to learn as much information as one's counterparty through legal means.[436]

A legislative prohibition on insider trading based on the equal access theory would thus prohibit trading on information not legally ascertainable by all and would lie against all lawfully unerodable information advantages.[437] As to a knowledge requirement, the theory prohibits trading on information by a trader who knows, or at least has reason to know,[438] that the information he is trading on is not and could not be known or learned by those with whom he is trading.[439]

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[435] Brudney (1979) *Harv L Rev* 340.

[436] Ibid. 346. *Cf.* Rider & French *The Regulation of Insider Trading* 2 and K E Scott "Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy" (1980) 9 *J Legal Stud* 801 804

[437] S S Kunkel "Insider Trading: A New Equal Access Approach" (1989) 15 *J Contemp L* 51 66.

[438] A legislative choice is to be made between prohibiting trading on inside information the trader knows not to be available to the persons he trades with, information he has reason to know is not available to them, or both. To prohibit trading on information that the trader has reason to know that his counterparties do not have access to, is a broader provision.

[439] Kunkel (1989) *J Contemp L* 66.

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While, according to the theory, it does not matter who the traders are, or whether they have a connection with the company in whose securities they are trading,[440] the theory prescribes a nuanced approach to directors' and managers' liability for insider trading when they deal with incumbent shareholders. It does not require a blanket ban against directors and managers trading with shareholders. Rather, it prohibits only directors and managers from trading with shareholders where those shareholders have no legal means of obtaining the information on which the director or manager's trade is based. Confidential information, for instance, known by directors and managers only, may therefore not serve as a basis for their trades. Once a shareholder would have had to, for example, break into a company's property, hack into its databases, or attend closed board meetings to obtain the information on which a trade is based, the director or manager's trade would be forbidden.

The implementation of the theory does present some challenges to the legislature. The prohibition on insider trading has to be formulated without the benefit of the limitation placed on liability, which a definition of 'insider' (or the limitation of liability to a circumscribed group of people) establishes. The determination of what conduct should be prohibited and what conduct should not, has to be done without the added certainty afforded by a prohibition aimed at addressing conduct by only a certain circumscribed group of people. This may lead to difficult legislative line-drawing decisions, notwithstanding the fact that the legislature could employ a knowledge requirement to limit liability. Particularly, 'access' is a fluid concept. Easterbrook[441] writes:

> People do not have or lack 'access' in some absolute sense. There are, instead, different costs of obtaining information. An outsider's costs are high; he might have to purchase the information from the firm. Managers have lower costs (the amount of a salary foregone); brokers have relatively low costs (the value of the time they spent investigating); Sherlock Holmes also may be able to infer extraordinary facts from ordinary occurrences at low cost. The different costs of access are simply a function of the division of labour. A manager (or a physician) always knows more than a

[440] R F Kidd "Insider Trading: The Misappropriation Theory versus an 'Access to Information' Perspective" (1993) 18 *Del J Corp L* 102 118.

[441] Easterbrook (1981) *Sup Ct Rev* 309.

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> shareholder (or patient) in some respects, but unless there is something unethical about the division of labour, the difference is not unfair.[442]

Easterbrook also argues that it is difficult to determine what type of 'access' the legislature must seek to ensure.[443] To my mind, however, the answer is clear: the theory should afford access by 'legal' means. A rule against the exploitation of inside information that could not be lawfully obtained by other traders, does not prohibit trading on an information advantage acquired through doing research or receiving investment advice based on financial market research.[444] A trader would not be able to successfully challenge a trade simply because a counterparty had an information advantage over him. If the claimant had been able to, through lawful means, place himself in as good a position as information can ensure, he would have no action. An action arising purely out of an information disadvantage would arise only under the parity of information theory. This equal access approach would, for instance,[445] allow a portfolio manager with twenty years' experience, to glean information from a certain set of events that X is going to happen and to trade on that information. She would not be prohibited from trading, as any other person could have become a portfolio manager, worked for twenty years and been able to glean the necessary information to make a similar trade. To avoid liability, a defendant would thus always be able to prove, as a defence, that the information she traded on was lawfully available to the counterparties in the market. To continue with the example, when accused of insider trading, she would be able plead the defence that her information advantage was acquired through skill, expertise or research, or a combination of the three.

Therein lies an important advantage of the equal access to information theory. It encourages traders to research the market, gather information and gain experience. This amounts to the

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[442] Easterbrook (1981) *Sup Ct Rev* 330.
[443] Also see G Lawson "Ethics of Insider Trading" (1988) 3 *Harv J L & P P* 727 752–758.
[444] Brudney (1979) *Harv L Rev* 361.
[445] See Lawson (1988) *Harv J L & PP* 757 where a similar example is provided.

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encouragement of conduct that promotes the more efficient allocation of resources. Brudney writes:

> Exploration for relevant corporate and economic information is a service of value in the functioning market. If the information is related to the assets or expected performance of the enterprise, the sooner it is found, the more accurately it is appraised, and the more immediately it induces a purchase or sale, the more precisely will the market price of the securities correspond to the value of the enterprise. The market will thus function efficiently to allocate savings to enterprises which are more profitable and divert them from enterprises which are less profitable. Moreover, the faster that information about a firm's value becomes available to the public, the less opportunity there will be for (and the less occasion for public fear of) trading on inside information.
>
> But for those who are not connected with a corporation to pursue or acquire such information requires expenditure of effort, time and money in research, and talent and training in analysis. To meet the costs of thus pursuing and analysing information, a return must be offered. One such return is the opportunity to capitalise on the value of being the discoverer of the information – the advantage obtained from having the first vision. Hence, market efficiency will be enhanced if persons are encouraged (by receiving the rewards of the bargain resulting from information advantages thus obtained) to seek such advantages, for purposes of either buying or selling particular securities.[446]

In this also lies Pothier's notion of a just reward, which he allowed the merchant for the diligence that enabled him to arrive at the market first. More than Pothier's merchant, however, the market researcher does not simply beat all others and therefore receives a reward; the market researcher is rewarded for fulfilling an important economic function: facilitating the accurate price signalling role played by share prices in the economy.[447] Once information relevant to the assets or the performance of a company who markets its securities is found, and a consideration of that information induces a purchase or sale, it means that the market price of the security will move closer to its underlying value.[448] The sooner the information is found, the sooner the price will more accurately reflect the security's true value and the market will

[446] Brudney (1979) *Harv L Rev* 341.
[447] Ibid.
[448] Ibid. 344.

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function more efficiently in allocating resources in accordance with the value of the relevant companies.[449]

The current Act, as it has been said, aims at the promotion of confidence in the South African financial markets, especially through promoting financial markets that are fair. That intention is irreconcilable with the notion that some traders, whether they be connected to the issuing company or not, are allowed to trade while knowing information that is not legally accessible to their counterparties. The equal access to information theory will best suit the objects of promoting confidence and fairness in the financial markets. Equal access has indeed expressly been recognised by the King Task Group. In its final report, it is declared that:

> In insider trading legislation, a balance has to be struck between, on the one hand, the need for the markets to be transparent so that investors would have confidence that the market, as far as possible, *is one based on equal access to knowledge* and, on the other, that the legislation must not be so designed that the ability to trade is not unreasonably restricted.[450] (My emphasis.)

The theory will give rise to prohibitions more directly and coherently connected to the objectives that the legislature has set out to pursue.[451] As it will be shown, prohibiting insider trading in pursuance of the equal access to information theory will also simplify the Act and specifically its definitions of 'insider' and 'inside information'. All a prospective trader would have to do, to ensure that she does not fall foul of the law, would be to ask whether she is in possession of inside information and to refrain from dealing with the information if her answer is in the affirmative. When a legal opinion is sought as to whether a proposed trade falls foul of the financial market laws, legal practitioners would have to address only one central issue: whether the trade is to be done on the basis of inside information.

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449 Ibid.

450 King Final Report 4 note 8.

451 *Cf*. Kidd (1993) *Del J Corp L* 106.

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The theory also fits well into the South African Constitutional dispensation. All law, including financial market law, is subject to the Constitution.[452] A law is valid only if it is consistent with the provisions of, and the values that underlie, the Constitution. One of these provisions is section 9, which entrenches the right to equality.[453] Equality is one of the founding values of the South African democracy.[454] Section 9 of the Constitution provides:

> (1) Everyone is equal before the law and has the right to equal protection and benefit of the law.
> (2) Equality includes the full and equal enjoyment of all rights and freedoms. To promote the achievement of equality, legislative and other measures designed to protect or advance persons, or categories of persons, disadvantaged by unfair discrimination, may be taken.
> (3) The state may not unfairly discriminate directly or indirectly against anyone on one or more grounds, including race, gender, sex, pregnancy, marital status, ethnic or social origin, colour, sexual orientation, age, disability, religion, conscience, belief, culture, language and birth.
> (4) No person may unfairly discriminate directly or indirectly against anyone on one or more grounds in terms of subsection (3). National legislation must be enacted to prevent or prohibit unfair discrimination.
> (5) Discrimination on one or more of the grounds listed in subsection (3) is unfair unless it is established that the discrimination is fair.

The Constitution provides a blueprint for, among other things, the legislative regulation of society, not only in the public, but also in the private sphere.[455] The equal access theory is in

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[452] Section 2 of the Constitution provides: 'This Constitution is the supreme law of the Republic; law or conduct inconsistent with it is invalid, and the obligations imposed by it must be fulfilled'. Section 8(1) of the Constitution provides: '(1) The Bill of Rights applies to all law, and binds the legislature, the executive, the judiciary and all organs of state'. Also see *Barkhuizen v Napier* 2007 (5) SA 323 (CC) par. 15.

[453] Section 9 of the Constitution.

[454] Section 2 of the Constitution provides in relevant part:
'The Republic of South Africa is one, sovereign, democratic state founded on the following values:
(a) Human dignity, *the achievement of equality* and the advancement of human rights and freedoms.' (Emphasis added.)

[455] D Moseneke "Transformative Constitutionalism: Its implications for the law of contract" (2009) 20 *Stell LR* 4; *Minister of Finance v Van Heerden* 2004 (6) SA 121 (CC); *Democratic Alliance v Masondo NO* 2003 (2) SA 413 (CC); *Van Rooyen v S* 2002 (5)SA 246 (CC); *Soobramoney v Minister of Health, Kwa-Zulu Natal* 1998 (1) SA 765 (CC); *Du Plessis v De Klerk* 1996 (3) SA 850 (CC); *S v Makwanyane* 1995 (3) SA 391 (CC). Also see K E Klare "Legal Culture and Transformative Constitutionalism"

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harmony with the blueprint. It overcomes the failings of the misappropriation theory and the fiduciary doctrine as it gives rise to a prohibition that would punish equally culpable behaviour equally:[456] everyone one in possession of inside information is prohibited from dealing with it in the markets. The theory therefore provides a meeting for the 'public law guarantee' of equality and the regulation of the situation where two parties enter into a contract of sale for shares on a state regulated exchange.[457]

Equal access to information in the financial markets is a goal especially worth pursuing in a country which, first, has had a historically skewed distribution of wealth and income, combined with financial opportunities being limited to a few. The theory will provide all investors trading on regulated markets with an acceptable degree of access to information. This would contribute to all members of the investing public having to bear similar risks. Secondly, through clarifying South Africa's financial market law, the equal access theory would increase South Africa's attractiveness to international investors. The world's securities markets are becoming increasingly globalised.[458] Technological development has provided investors with nearly unfettered access to the securities markets of other countries.[459] Seen from the individual businesses' perspective, it now has the opportunity to attract capital investment from investors all over the world.[460] The equal access to information theory provides the chance of a break from the outdated bases of regulation still adhered to in, for

(1998) 14 *SAJHR* 146; D Bhana & M Pieterse "Towards a Reconciliation of Contract Law and Constitutional Values: *Brisley* and *Afrox* Revisited" (2005) 122 *SALJ* 865; and D D Tladi "Breathing Constitutional Values into the Law of Contract: Freedom of Contract and the Constitution" (2002) 35 *DJ* 306.

[456] Also see Kidd (1993) *Del J Corp* 135. Kidd makes a further policy argument for the access to information theory: that investors should be discouraged from attempting to obtain non-public information illegally.

[457] For a discussion of 'the intractable question of the intersection between public law guarantees, as provided for in sections 9 to 35 of our Bill of Rights, and the private law regulation of contract between private parties' see Moseneke (2009) *Stell LR* 1; Bhana & Pieterse (2005) *SALJ* 865 and Tladi (2002) *DJ* 306.

[458] M I Steinberg *International Securities Law: A Contemporary and Comparative Analysis* (1999) 105.

[459] J A Kehoe "Exporting Insider Trading Laws: The Enforcement of US Insider Trading Law Internationally" (1995) 9 *Emory Int'l L Rev* 345.

[460] Steinberg *International Securities Law: A Contemporary and Comparative Analysis* 105.

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example, the United States, and would provide a fair market that would, all other things being held constant, rightly entice more foreigners (and, for that matter, South Africans), to invest in South African securities. The result is highly valued modern societal objectives: enlarging the pool of capital feeding the most promising companies and keeping the markets for their securities liquid.

The challenges presented by the implementation of the equal access to information theory are negligible; the benefits would be significant. The equal access theory is to be employed as the basis for the regulation of insider trading in South Africa.

2 4 Conclusion

An express or implied legislative choice of a single basis for the regulation of insider trading in South Africa will, in and of itself, go a long way in clarifying its insider trading provisions. That choice must be informed by the legislative objects of promoting confidence and fairness in the financial markets. The theoretical bases for the regulation of insider trading include non-market related and market related theories of regulation. The non-market related theories are the fiduciary doctrine and the misappropriation theory. The market related theories are the parity of information and equal access to information theories.

The fiduciary doctrine was never intended to address a market wrong. It is a historic relic of outdated eschewed thinking on insider trading. It fails to explain the wrongfulness of insider trading between directors and individual incumbent shareholders; the wrongfulness of insider trading between directors and purchasing or prospective shareholders; and the wrongfulness of insider trading in bonds and derivatives generally. The misappropriation theory was born out of the failings of the fiduciary doctrine. It enlarges the scope of a prohibition on insider trading to include those trading with inside information who do not owe duties to the issuer,

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but rather to the firm with whose information the trade is being made. At the least, if one were to be of the opinion that a prohibition on insider trading should be broader in its scope than merely prohibiting breaches of fiduciary duty, the misappropriation theory provides some answers. Yet, it gives rise to numerous anomalous results in addressing a market wrong. The theory still fails to explain the wrongfulness of the misappropriator's conduct in relation to those he deals with in the financial markets. If there is no breach of a duty owed to the company with whose information the trade is made, the misappropriation theory views the conduct as lawful. The theory thus arbitrarily declares unlawful some instances of unfair trading, while turning a blind eye to others. It does not prohibit all trades that, if allowed to proliferate, will be detrimental to market fairness and the confidence the public has in the financial markets. It fails to prohibit all trades with inside information. With whomever one agrees as to what is fair in Cicero's grain merchant example, one thing stands above question: not one of the old writers preferred to give some of the grain merchants the right to sell on the information not available to the Rhodians and others not. The fiduciary duty doctrine and the misappropriation theory, as bases for the regulation of insider trading, are irreconcilable with the underlying principle this evidences: equally culpable conduct must be punished equally.

The fiduciary duty doctrine's and the misappropriation theory's failures are the result of their seeking to address a market wrong by finding the unlawfulness of the conduct they seek to prohibit outside the market. The fiduciary duty doctrine recognises a duty owed by directors to the shareholders of a company. The wrongfulness of conduct in that context lies in the breach of the duty owed to the shareholders. The misappropriation theory recognises a duty owed by the possessor of information to the owner of the information. Neither of these duties is born out of the rights and obligations at play in the financial markets.

Confidence in and the fairness of the financial markets relate to confidence in and fairness of the markets and the relationships in those markets. They do not relate to the inner workings of companies or duties owed to sources of inside information. To formulate a theory of wrongfulness in the financial markets, one has to consider those rights and obligations, and the

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overarching object of regulating those markets. If one were to keep to duty-speak, a duty must be recognised to the market as a whole, including all its participants.

The market theories of regulation recognise as much. The parity information theory is, however, not a suitable choice for the regulation of insider trading. It will give rise to duties and prohibitions detrimental to, at least, market liquidity. It has as its object a practically unworkable egalitarian utopia. It would unreasonably restrict trade in securities. The most apposite duty, I submit, would be one not to deal with information that is not lawfully available to all, as dictated by the equal access theory. The equal access theory is also the regulatory basis that best suits the object of promoting confidence and fairness in the financial markets. It is reconcilable with Pothier's idea of affording traders just rewards, and it fits well into the South African constitutional legal landscape. The theory gives rise to prohibitions more directly and coherently connected to the wrongfulness inherent in insider trading. It must be employed as the single basis for the regulation of insider trading in South Africa.

Our legislature has recognised the need to promote confidence and fairness in the South African financial markets. Yet it has left definitions, specifically those of 'inside information' and 'insider', dictated by the fiduciary doctrine and the misappropriation theory, in our legislative scheme. I have submitted that the most suitable basis for the regulation of insider trading in South Africa is the equal access theory. The definitions of 'inside information' and 'insider' are to be formulated in accordance with that theory. I address each definition below.

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3 1 Introduction

Information is central to investing successfully in the financial markets. As Kaufman J writes:

> Our era has been aptly styled, and well may be remembered as the 'age of information.' Francis Bacon recognized nearly 400 years ago that 'knowledge is power,' but only in the last generation has it risen to the equivalent of the coin of the realm. Nowhere is this commodity more valuable or volatile than in the world of high finance, where facts are worth fortunes. . . .[461]

The definition of inside information is an important part of any legislative scheme aimed at regulating insider trading. For it is ultimately inside information (and not necessarily the position held by an insider) that enables a person to beat the market. On publication, it is the inside information that affects the market price of a security. The insider, by knowing this information to the exclusion of other traders prior to the information's wider dissemination, is able to predict the market price movement that is likely to be brought about by that wider dissemination.

Many different types of information influence the price of many different types of security. The investor is particularly interested in the characteristics of an instrument that is likely to influence its future value. This includes, for instance, the size of the payment that is promised to a prospective holder of a security in future or the price that will be realised on the sale of the security; when the promised payment is to be made; the likelihood that it will be made; and the circumstances under which the payment is to be made.[462] De Bondt, dealing with equity, also lists the long-run equity risk premium (the difference between the rate of return on an investment in private equity and a largely risk-free investment, such as in government securities) as a factor that will be considered by investors.[463] It is not clear why De Bondt would limit his submission to

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[461] Kaufman J in *SEC v Materia* 745 F 2d 197 (1984).
[462] Cecchetti *Money, Banking and Financial Markets* 45.
[463] See G J De Bondt "Determinants of Stock Prices: New International Evidence" (2008) 34 *J of Portfolio Management* 81 81.

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equity and risk-free investments. It seems to me that opportunity cost, relative to any other type of investment, would be a relevant consideration to any prospective investor. Be that as it may, when people act rationally, any information relating to these types of variables will influence security prices in the long run. In the short run they are also said to be influenced by exchange rates, commodity prices, momentum and seasonality.[464] Whereas information can be grouped under different heads, to develop a closed list of types of information that will influence different types of securities, is a near impossible task. What is rather required is the formulation of broader, principle-based requirements to define inside information.

In regulating information asymmetries in the financial markets, a balance has to be found between over and under regulation. The definition of inside information is important in performing this balancing act. If the definition is too narrow, the ambit of the prohibition would be too narrow, the market would be perceived as unfair, and market liquidity would suffer. If the definition is overbroad, the ambit of the prohibition would be overbroad and market liquidity would suffer. In addition, care must be taken not to distort the incentives at play in the financial markets.

Market actors do market research for the prize of being able to beat the market. The research enables them to invest successfully. At the same time, they promote the accuracy of market prices. As it has been said, when market actors purchase securities on the basis of information they have gathered, the demand for the security they trade in increases; this raises prices and incorporates the researched information into the market price of the relevant security. It is through this gathering and analysis of information, and subsequent trading, that the market is able to correctly price a security.[465] The majority (or at least some, depending on one's worldview) of information acquired in financial markets comes to traders deservedly. They lawfully engage in market research to gain an advantage over less informed traders. Traders who come to know information in this way deserve their information advantage and must be

[464] See De Bondt (2008) *J of Portfolio Management* 82.
[465] J E Fisch "Picking a Winner" (1995) 20 *J Corp L* 451 451.

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allowed to trade freely with it. The trader must be economically rewarded for the purpose he fulfils in the system. The legislature must therefore be careful that the definition does not in effect prohibit a trader from trading in instances wherein his information advantage was acquired through lawful enterprise, hard work and endeavour. It must take care not to distort the incentives that drive the process behind accurate market prices.[466] A question that thus must be considered when formulating a definition of inside information is: where is the line to be drawn between information that resulted from lawful market research and inside information? Or, how is the distinction to be made between inside information and, as it is phrased in the American decision of *In re Cady, Roberts & Co*,[467] information 'arrived at as result of perceptive analysis of generally known facts'.

As a starting point I accept that a principle-based approach will in itself work to define the ambit of any prohibition. If it is clear from a legislative scheme what the wrong sought to be addressed is, the definitions will be interpreted (and circumscribed) in that context. If the underlying principles are clear, the ambit of the prohibition will be clearly determined. The present definition of insider trading fails to evidence one, clear theory of regulation. There is also no principle-related progression in the legislative history of the South African definition of 'inside information'. It has gone through many changes. The 1973 Companies Amendment Act[468] made it an offence for a person to deal in securities 'on the basis of unpublished price-sensitive information'.[469] According to section 440F(2)(a) of that Act[470] inside information had to be information that related to the internal affairs of a company or its operations, assets, earning power or involvement in a takeover.[471] To qualify as inside information, the information had not to have been available to the 'reasonable investor' in the market, for the

[466] J R Beesom "Rounding the Peg to the Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory" (1995) 144 *U Pa L Rev* 1077 1142.
[467] *In re Cady, Roberts & Co* 40 SEC 907 (1961) 915.
[468] Companies Act 61 of 1973.
[469] Section 440F(1) of the Companies Act 61 of 1973.
[470] Companies Act 61 of 1973.
[471] Jooste (2000) *SALJ* 290.

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security in question and the information must have been reasonably expected to affect 'materially' the price of the security if it were to become so available.[472] General information that related to securities or their issuers did not qualify. Obviously, this would have solidified the market. Jooste gives examples of information that would not have qualified as inside information: information relating to the industry in which the company did business; information that applied to the economy in general; information of government's diplomatic activities in, say, a country that presented a new market for a certain company's goods; and information emanating out of a confidential reserve bank briefing.[473]

The King Task Group on Insider Trading proposed a new definition for inside information. They made the following suggestions:

> 3.2.1 Inside information is defined in section 1 of the proposed legislation as information which is obtained or learned as an insider, which if it were made public would be likely to have a material effect on the price or value of any security or financial instrument, which is specific or precise and which has not been made public.
>
> 3.2.2 The task group decided that the impact of the information should be 'material' rather than 'significant' (which is the word used in the legislation in the United Kingdom) because of the extensive case law in South Africa on the meaning of material, particularly in relation to fraud.
>
> 3.2.3 Section 3 of the proposed legislation defines the circumstances in which information is deemed to have been made public as well as the circumstances in which information may, in the discretion of the court, be treated as having been made public. These circumstances are specifically stated not to be exhaustive.[474]

[472] Section 440F(2)(a)(ii–iii) of the Companies Act 61 of 1973.
[473] Jooste (2000) *SALJ* 290.
[474] King Final Report 10.

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The suggestions were all adopted in the Insider Trading Act.[475] The legislature, in enacting the Securities Services Act, kept the definition as is, with one minor adjustment.[476]

3 2 Inside information in the Financial Markets Act

The Act inherited its definition of inside information from the Securities Services Act. It has been amended once to include information that would, if it were to be made public, have an effect on the price of a derivative instrument related to a security listed on a regulated market.[477] The current definition of the term in South African law is as follows:

> 'Inside information' means specific or precise information, which has not been made public and which—
> (a) is obtained or learned as an insider; and
> (b) if it were made public would, be likely to have a material effect on the price or value of any security listed on a regulated market or any derivative instrument related to such a security.[478]

For it to be proved in a South African tribunal that something is inside information, the following requirements must thus be fulfilled. There must be information; that is specific or precise; that has not been made public; that is 'likely' to have a 'material' effect on the price or value of any security listed on a regulated market or any derivative instrument related to such a security; and that was obtained or learned as an insider. I deal with each requirement below. I then briefly discuss the definitions of inside information in other jurisdictions, including the United States, Australia and the European Union. I finally argue for a new approach in accordance with the equal access theory.

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[475] Insider Trading Act 135 of 1998.
[476] Section 72 of the Securities Services Act 36 of 2004.
[477] The amendment was made through the Financial Sector Regulation Act 9 of 2017.
[478] Section 77 of the Financial Markets Act 19 of 2012.

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3 2 1 If it were to be made public, would be likely to have a material effect on the price or value of any security listed on a regulated market or of any derivative instrument related to such security

For the information to be recognised as inside information, the Act requires it to be likely to have a material effect on the price or value of a listed security, if it were to be made public.[479] Jooste and Blackman seem to interpret the materiality requirement in the previous Acts as requiring the information in itself to be material.[480] Clearly, however, the Act requires the 'effect' such information would have if it were to be made public, to be material.

This requirement recently received the attention of the Gauteng Local Division of the High Court, Johannesburg, in *Zietsman and Harrison and White Investments (Pty) Ltd v Directorate of Market Abuse*.[481] The case concerned a purchase of the securities of a company that was in financial difficulty because of being over indebted. In reaching its conclusion, the court not only interpreted the provisions of the Act, but also made additions to the express words used by the legislature. The judgment is badly written and open to much criticism, much of which falls beyond the scope of this work. Where there is no basis for the court's interpretation I do, however, say so. The judgment is indicative of the mess that ensues when less than coherent legislative provisions fall to be interpreted and applied by inexperienced judges.

During the middle of 2010 Harrison and White put into effect a strategy to begin operating in the renewable energy sector. On 28 August 2010, the chairman of its board, Zietsman, opened an FNB share trading account, which he used to purchase 15 000 shares in a company by the

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479 Section 72 of the Securities Services Act 36 of 2004.

480 See Jooste (2006) *S African LJ* 443 and Blackman et al *Commentary on the Companies Act* (Revision Service 3 2006) 5-394-24.

481 [2015] ZAGPPHC 651 (24 August 2015) (*Zietsman*).

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name of AC Towers. He continued to purchase shares in AC Towers at regular intervals.[482] From 31 August 2010 to 4 November 2010, Zietsman purchased 835 805 more shares in 23 trades. Both Zietsman and Harrison and White continued to purchase AC Towers shares up to 14 March 2011.[483] In November 2010 Zietsman was instructed by Harrison and White to acquire AC Towers. So was Ralston, Harrison and White's managing director.[484]

On 24 January 2011, the Industrial Development Corporation addressed a letter to AC Towers, which read as follows:

> The IDC has agreed to make available to your organisation a total funding package of R99 000 000 (Ninety-Nine Million Rands). The funding has been approved substantially on the terms and conditions discussed with you. Agreements are being prepared which will contain all the terms of the facilities and which will, when duly signed, form the agreement between the IDC and yourselves. . . .

Attached to this approval letter was a term sheet setting out the details of the finance that had been approved, and certain conditions precedent that the Industrial Development Corporation required to be included in the envisioned agreement.[485]

On 26 January 2011, a meeting was held between the respondents and members of the board of AC Towers, including a Mr Jacques De Villiers.[486] This meeting was central to the issues that required resolution by the court.[487] At the meeting De Villiers said that AC Towers had secured a possible loan facility of R99 million from the Industrial Development Corporation on an 'approval in principle basis'. The other AC Towers representatives present at the meeting also indicated that no contracts had been concluded for the facility and that no substantiating information had been made available in support of the grant of the funding. De Villiers also disclosed that the Industrial Development Corporation had begun to do, or was

[482] Ibid. 5.
[483] Ibid.
[484] Ibid. 12.
[485] Ibid. 6.
[486] Ibid.
[487] Ibid.

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about to begin, a due diligence of AC Towers.[488] However, the court specifically recorded that no documents were presented to the meeting about the alleged funding. De Villiers also did not inform those present, even though he was specifically asked at the meeting, what the conditions precedent to the funding were, whether AC Towers was capable of complying with any conditions precedent, what the repayment terms were, and what any of the other terms of the funding were.[489]

On 28 January 2011 a first Stock Exchange News Service (SENS) announcement was published by AC Towers in which shareholders and the market were informed that:

> the company was successful in securing debt funding and is in the process of finalising the terms of the debt facility with the potential funder which, when successfully concluded, could affect the price of the company's shares.

What would be the first of two relevant SENS announcements did not disclose the amount and other details of the facility to the market nor the details of the funder. A decision had been made by the board of AC Towers that, although AC Towers had received the approval letter, those details ought not to be disclosed before the agreements with the Industrial Development Corporation were concluded.[490] The publication of the first SENS announcement had no effect on the share price of AC Towers.[491]

After the meeting of 28 January 2011, the appellants continued to acquire shares in AC Towers. On 10 March 2013, a day before a SENS announcement made public the amount of the loan and the identity of the lender, Harrison & White made a further purchase, far in excess of any prior ACT share acquisition, of 14 131 977 shares with a value of R1 554 517.[492] The fact that final loan agreements were concluded, the amount of the loan and the identity of the lender

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488 Ibid. 6–7.
489 Ibid. 7.
490 Ibid.
491 Ibid.
492 Ibid. 13.

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were made known to the public only by a further SENS announcement on 11 March 2011.[493] It advised shareholders that:

> AC Towers is pleased to announce that an agreement has been entered into with the Industrial Development Corporation (IDC) in respect of a R99 million funding facility, staggered over the next six years at market related rates to assist with capital expenditure and working capital requirements of the group.[494]

Subsequent to but still on the same day as this further SENS announcement, the AC Towers share price jumped from 11 cents to 17 cents a share.[495] As an aside, neither Zietsman nor Harrison and White sold their shares in time to make a profit. They suffered losses, as AC Towers was subsequently placed in liquidation.[496]

The case was brought before the enforcement committee in terms of section 99 of the Act. It found that the amount of the loan (R99 million) and the identity of the lender (the Industrial Development Corporation) constituted inside information.[497] Zietsman and Harrison and White were found guilty of the dealing offence and dealing for another.[498] The dealing offence is contained in section 78(1)(a) of the Act, which provides that '[a]n 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 or in derivative instruments related to such securities, to which the inside information relates or which are likely to be affected by it, commits and offence.'[499] The dealing for another offence is contained in section 78(2)(a) of the Act. It provides that '[a]n 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 or in derivative instruments related to such securities, to which the inside information relates or which are likely to be affected by

493 Ibid.
494 Ibid. 8.
495 Ibid. 14.
496 Ibid.
497 Ibid.
498 Ibid.
499 Section 78(1)(a).

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it, commits an offence.'[500] They were convicted, and an administrative penalty of R1 million was jointly and severally imposed.[501] On appeal to the High Court, they argued that the disclosure of the amount of the loan during January 2011 was not specific or precise information. They argued that the information was vague since: no loan agreement had been concluded in writing; there were unfulfilled conditions precedent; there was uncertainty over whether AC Towers would actually ever be able to access the funds, the loan only having been approved provisionally; and lastly, that the information they had did not differ in any material respect from information that had already been made public in the first SENS Bulletin.[502]

Concerning the requirement that the information would be 'likely' to have a material effect on the price or value of any security listed on a regulated market, the court adopted the definition of the word 'likely' in *Tshishonga v Minister of Justice and Constitutional Development*.[503] In that judgment it was said that 'likely' means 'less than a probability but more than a mere possibility'. It further found, with reference to the Australian case of *Boughey v R*,[504] that 'likely' is synonymous with 'probable'. 'Probable', reasoned the court, means 'more probable than not' and is to be compared with a term referring to a lesser contingency such as 'possible'.[505]

The court held that when information is assessed for the purposes of determining whether it would be 'likely to have a material effect on the price or value of a security', it is to be assessed in the context in which it is used. The information about the loan, found the court, the fact that the identity of the lender and the terms of the loan being unknown notwithstanding, had the capacity to materially affect the share price. This was the case as the loan represented a

[500] Ibid.
[501] Ibid.
[502] Ibid. 14–15.
[503] *Tshishonga v Minister of Justice and Constitutional Development* 2007 (4) SA 135 (LC) pars. 167–168.
[504] [1986] 65 ALR 609.
[505] *Zietsman* 18.

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significant lifeline to the embattled AC Towers. The amount of R99 million would be viewed by the 'reasonable investor' as sufficient for a small company requiring funding. The fact that the Industrial Development Corporation was the lender would, held the court, signify to the reasonable investor that the terms of the loan would be less onerous than those that a commercial bank would impose.[506] The court furthermore considered the actual increase in the share price of the shares to conclude that the information released in the second SENS announcement indeed had the capacity to affect the share price.[507]

Whether the information is price sensitive is further to be determined with reference to the reasonable investor and whether he would regard the information as relevant to a decision to deal in the securities or not.[508] That one has to have reference to the reasonable investor and whether he would regard the information as relevant to deal in securities or not, is the court's own invention. It is not a requirement of the Act.

3 2 2 Specific or precise

For information to be recognised as 'inside information', the Act also requires that it must be 'specific or precise'. The *Oxford Dictionary of English* defines 'specific' as 'clearly defined or identified'[509] whereas 'precise' is defined as 'marked by exactness and accuracy of expression or detail.'[510]

This phrase was also dealt with in the *Zietsman* judgment. The court held that the mere fact that final loan agreements had not been signed, was not a reason why the information known

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506 Ibid. 19.
507 Ibid. 19.
508 Ibid. 34.
509 Soanes & Stevenson *Oxford Dictionary of English*.
510 Ibid.

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to the appellants cannot be described as specific and precise. The prospect of the conclusion of a loan agreement with the Industrial Development Corporation for R99 million described a set of circumstances that could realistically, or on the probabilities, materialise,[511] and, presumably, was specific inside information in itself. In sum, the court held the following principles to apply to South African law: for information to be specific or precise it is not required that the circumstances or event to which it relates be final. Information relating to circumstances or an event in an intermediate phase could still be specific and precise and constitute inside information.[512]

3 2 3 Information

The Act prohibits certain dealings with inside 'information'. 'Information' is something that is 'conveyed or represented by a particular arrangement or sequence of things'.[513] It is to be juxtaposed with 'data'. 'Data' is 'facts and statistics collected together for reference or analysis'.[514] The distinction between the two concepts lies in the fact that information is a refined form of data. It is data converted from raw material and put into a meaningful form. In other words, that which is prohibited, as the prohibition relates to information, is trading with something that already has meaning to a certain degree.

3 2 4 The non-public requirement

The Act also includes a separate section, section 79, which deals specifically with what is to be understood under information 'which has not been made public'.[515] Section 79 provides:

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[511] *Zietsman* 15.
[512] Ibid. 33.
[513] Soanes & Stevenson *Oxford Dictionary of English*.
[514] Ibid.
[515] Section 77 of the Financial Markets Act 19 of 2012.

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> For the purposes of the definition of 'inside information', information is regarded as having been made public in circumstances which include, but are not limited to, the following:
> (a) When the information is published in accordance with the rules of the relevant regulated market; or
> (b) when the information is contained in records which by virtue of any enactment are open to inspection by the public; or
> (c) when the information can be readily acquired by those likely to deal in any listed securities—
> (i) to which the information relates; or
> (ii) of an issuer to which the information relates; or
> (d) when the information is derived from information which has been made public.

The section provides an open list of situations in which information would be regarded as not having been made public. In other words, information that falls within these categories, and some types not mentioned, is not inside information.

3 2 5 Learned or obtained as an insider

Inside information must be learned and obtained as an insider. In other words, the person who learns or obtains the information must be an insider when he learns it or he obtains it. When information, which would satisfy every other requirement for inside information, is obtained by someone who is not an insider at the moment when he obtains it, the information is not inside information.

The two actions by which the inside information must come to the knowledge of an insider is provided as 'learned or obtained'. The two verbs are divided by 'or' rather than 'and', which means that either 'learned' or 'obtained', standing on its own, would suffice. The mere fact that these verbs have been included to describe the way in which the person came upon the inside information, suggests that the legislature had it in mind that being in possession of inside information is not sufficient to satisfy this requirement in the definition.

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To obtain is to 'get, acquire or secure (something)'.[516] To 'learn' is to 'gain or acquire knowledge of or skill in (something) by study, experience, or being taught'.[517] *John M'Tali v R*[518] dealt with legislation where 'obtained' was used in relation to illegal beer. The term was used in the following context: 'shall obtain by purchase, barter or in any other manner'. It was argued that 'obtain' must mean 'obtain from someone else.'[519] Maasdorp C.J. held, however, that:

> the word "obtain" has not this restricted meaning in the dictionary, and from the original derivation of the word we could not arrive at that meaning. Anyone who holds anything has obtained it. He may have acquired it through natural agencies.[520]

S v Scher[521] dealt with a provision in the regulatory scheme applicable to livestock and meat control, which provided that a retail butcher may sell meat 'obtained' only from specified sources. Scher, a retail butcher, operated his butchery under a registration certificate containing the following provision:

> The holder shall *obtain* meat only from a public auction conducted in a controlled area under the supervision of the Board, or from the Board, or from a person registered with the Board as a person who may deal in the course of trade with meat in a controlled area. (Emphasis added.)

Scher also farmed with sheep and cattle. From time to time, so it was testified, Scher slaughtered stock on the farm to satisfy his household needs and to feed his servants.[522] For this, the meat would be brought from Scher's farm to Durbanville, where he lived and conducted the retail butchery business. As it happened, by accident on Scher's version, meat from his farm was sold in his butchery. He was charged for and convicted of contravening his

516 Soanes & Stevenson *Oxford Dictionary of English*.
517 Ibid.
518 1908 ORC 25.
519 *M'Tali v Rex* 1908 ORC 24.
520 Ibid. 25.
521 1968 (1) SA 239 (C).
522 *S v Scher* 1968 (1) SA 239 (C) 239H.

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registration certificate. On appeal Scher argued that 'obtain' as used in the share certificate should be interpreted as synonymous with 'acquire'. With reference to cases such as *Wessels v De Klerk and Another*[523], *S v Botha*[524] and *Transvaal Investment Co. Ltd v Springs Municipality*[525] he argued that to 'acquire' meat postulated two parties; the one acquiring it from the other. As such, Scher's conduct was not governed by the condition in the registration certificate. The court of appeal, after referring to the dictionary definitions of 'obtain' and 'acquire', held as follows:

> For the purposes of the present case it seems to be unnecessary to determine whether the concepts conveyed by these two words are identical. I shall assume for the purposes of this case that they are. In their ordinary meaning, however, *neither of these words necessarily convey that a person can only obtain or acquire an object if he does so from another person*. Nor is there anything in the context – otherwise than there was in the case of *The Transvaal Investment Company Ltd v Springs Municipality*, supra – of condition 5, or in the conditions read as a whole, or in the conditions read in the light of the regulations promulgated under Proc. R.200, to suggest that the word "obtain" was limited in its meaning to those cases where the obtaining was by one person from another. Mr Levy conceded – indeed he had little option but to do so – that condition 5 referred to the obtaining of the meat to be sold, and not to the obtaining of the animal from which the meat was derived. Meat would be "obtained", in one of the ordinary meanings of that word, as the result of the slaughter of a cow, irrespective of whether the slaughtered cow and the meat were owned by one and the same person. Had condition 5 used the word "acquire" the meaning would have, in my view, been the same.[526]

Minister for Provincial and Local Government of the RSA v Unrecognised Traditional Leaders of the Limpopo Province, Sekhukhuneland[527] concerned the interpretation of section 44(1) of the Promotion of Access to Information Act,[528] but also drew the court into a debate about what the word 'obtain' means. That Act was enacted in accordance with the legislature's obligation to enact legislation to give effect to the right to access to information enshrined in

[523] 1960 (4) SA 310 (T).
[524] 1966 (2) SA 517 (T).
[525] 1922 AD 337.
[526] *S v Scher* 1968 (1) SA 239 (C) 242A–G.
[527] 2005 (2) SA 110 (SCA).
[528] Act 2 of 2000.

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the Bill of Rights.[529] According to section 44(1) the information officer of a public body may refuse a request for access to a record of that public body should the record include information 'obtained or prepared' for the purposes of assisting to formulate policy or take a decision in the exercise of a power or performance of a duty conferred or imposed by law.[530]

The appeal court held that 'obtained or prepared' does not mean that the information had to be 'commissioned' by the state. The threshold was low, being that the state must merely have 'obtained' the information.[531] The Supreme Court of Appeal accepted that the word 'obtain' is capable of both a narrow and a wide meaning.[532] The court found that the narrow meaning of 'obtain' was 'to be preferred' in the context. The term thus was held to mean 'procuring of information.'[533] The term is thus open to a broad and more than one interpretation. It is also able to include 'acquire' and 'procure'.

3 3 Inside information in other jurisdictions

The Financial Markets Act's requirements are similar to its international counterparts. In fact, their formulation evidences the clear influence of other jurisdictions.

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[529] Section 32 of the Constitution:
(1) Everyone has the right of access to –
(a) any information held by the State, and
(b) any information that is held by another person and that is required for the exercise or protection of any rights.
(2) National legislation must be enacted to give effect to this right, and may provide for reasonable measures to alleviate the administrative and financial burden on the State.

[530] Section 44(1)(a)(i) of the Promotion of Access to Information Act 2 of 2000.

[531] *Minister for Provincial and Local Government v Unrecognised Traditional Leaders, Limpopo Province (Sekhukhuneland)* 2005 (2) SA 110 (SCA) par. 10.

[532] Ibid. par. 16.

[533] Ibid. par. 17.

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3 3 1 The United States

As it will be shown, in the United States the concept of inside information has been developed and expanded by the courts. The broad anti-fraud Rule 10b-5 does not contain a definition of, or even a reference to, inside information. The jurisdiction's duty to abstain from trading or to disclose information, in accordance with the Rule and commonly referred to as the 'abstain or disclose duty',[534] has been developed to require abstention or disclosure of information only if the trader has information that is both 'material' and 'non-public'. These are the two main requirements for inside information.

The requirement of materiality is more encompassing than in South Africa. As it has been said, in South Africa the effect on the price of a security upon the release of the information must be material; according to the United States' approach, the information itself must be material. As it will be shown below, the test of materiality in the United States incorporates a test for the information's effect on the price of the security, the specificity of the information, and a range of other factors.

The development of inside information as a concept started in *Speed v Transamerica Corp.*[535] The case concerned three class actions brought in the District Court of Delaware by stockholders and former stockholders of a company called Axton-Fisher Tobacco. Prior to April 30, 1943, Axton-Fisher had outstanding three classes of stock: preferred stock, class A stock, and class B common stock.

In 1944 Speed instituted action on behalf of the class A and B stockholders who had sold their stock to Transamerica after a public offer made by Transamerica by letter in November 1942

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[534] *Langevoort on insider trading* (Rel 7 4/2009) 5-1.
[535] 235 F 2d 369 (1956).

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at $40 and $12 per share, respectively. The written offer for the shares had been made to all Axton-Fisher's minority stockholders. The sellers alleged that at the time of the sale the true value of the class A stock was more than $200 per share. It was alleged that Transamerica deceived the sellers into selling their shares. The sellers sought judgment for an amount equal to the difference between the sales price and the alleged true value of the shares.[536]

The basis of their claim was that in accepting Transamerica's offer, they had no option but to rely on the Axton-Fisher annual report for 1941, and a letter that accompanied the report, to determine the value of their shares. Transamerica had caused the letter to be mailed to Axton-Fisher's shareholders. The 1941 report showed the average value of Axton-Fisher's tobacco inventory to be over seven and a half million dollars. The accompanying letter created a negative image of the company. It showed a decline in sales and net income since 1938.

The complaint alleged that at the time when the plaintiffs sold their stock, the Axton-Fisher tobacco inventory had a real value in excess of seventeen million dollars and its earnings were improving.[537] The sellers, it was argued, should have been informed of these facts before the sale.[538] Transamerica therefore failed to disclose facts materially affecting the value of the stock.[539] The sellers thus claimed the difference between the sales price and the alleged true value.

The court found that Transamerica was, in addition to being a majority stockholder of Axton-Fisher, also in control of the company, 'at least in the sense that it possessed full power of control.'[540] It possessed information that the cash realisation value of Axton-Fisher's assets,

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536 *Speed v Transamerica Corp* 99 F Supp 808 (1951) 812.
537 Ibid. 812.
538 Ibid. 812.
539 *Speed v Transamerica Corp* 235 F 2d 369 (1956) 371.
540 *Speed v Transamerica Corp* 99 F Supp 808 (1951) 828.

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represented by its large tobacco inventory, was far greater than the book value recorded in Axton-Fisher's financial statements, as the big increase in the market value of the tobacco, not shown in the published statements, confirmed.[541] The information that related to the appreciation in value was known to Transamerica 'by virtue of its inside position' and was neither publicly disclosed nor made known to the plaintiffs.[542]

The court further found that the price Transamerica paid for the shares that it purchased from the plaintiffs was far below the redemption or liquidation value of the shares.[543] The court identified three requirements for inside information: that it comprises material facts that would influence the value of the stock if disclosed; that it would be known by the insider by virtue of his inside position; and that it would affect the judgement of traders.[544]

Kohler v Kohler[545] followed *Speed* and fleshed out these requirements. An action was brought by Walter Kohler (Kohler) against the Kohler Corporation (Kohler Co). Kohler sought damages, which he alleged he suffered as a result of a sale of Kohler Co common stock by him to Kohler Co. He alleged that he was induced to sell his stock by 'misrepresentation, half-truths, and omissions' made by insiders of the company and that, as a result, he sold his stock at $10 per share less than its 'actual' or 'fair market' value.[546]

The transaction was one far removed from the anonymous type of transaction found on the stock markets. Kohler had been a shareholder of Kohler Co from 1931 to 1953. He owned more than 10% of the shares of the company's common stock. He was also employed by the company from 1925 to 1947 and had been a director for a large part of that time. Kohler Co

[541] Ibid. 828.
[542] Ibid. 828.
[543] Ibid. 828.
[544] Ibid. 829.
[545] 319 F 2d 634 (7 Cir 1963).
[546] Ibid. 638.

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was a closely held corporation, having had only twenty-six common stockholders at the time Kohler sold his stock, many of whom were related to Kohler.

Kohler's uncle was the president and chairman of the board of directors. Kohler wrote to his uncle informing him of his plans to buy stock in Vollrath Company, of which Kohler was the president. He intended to exercise an option to this effect, but in order to do so he had to sell his Kohler stock. His uncle consulted with the directors and officers of Kohler Co. It was decided that one Johnson, a partner in an accounting firm that handled Kohler Co's audits, should act as an intermediary and meet with Kohler to negotiate the terms of the sale. Kohler's uncle informed Kohler that Johnson had 'available the facts which might play a part in a discussion of values'.[547]

Kohler informed Johnson that he had a price of $125 per share in mind. Johnson mailed Kohler with statistical data and a letter including the following passage:

> At the time of our discussion last Friday afternoon, it was agreed that I would furnish you with statistical data that I had used in projecting the possible value of Kohler Co common stock. These projections are based upon average earnings and other data of Crane Company and American Radiator & Standard Sanitary Mgf. Co. I believe that these schedules are self-explanatory but should any question occur to you, I shall endeavor to answer it.[548]

The data provided to Kohler included a series of ten projected values of Kohler Co stock. The values ranged from $58.83 to $149.38. They were based on certain comparative ratios of Kohler Co's competitors, Crane and American Standard, whose stocks were publicly traded. Kohler identified three pieces of inside information that he contended had unlawfully not been

[547] Ibid. 637.
[548] Ibid. 637.

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provided to him: the accounting practices relating to Kohler Co's pension plan; certain financial data relating to the year of the sale; and a tax refund that accrued to the company.

The court referred to the 'underlying principles' of *Speed*[549] and then held as follows:

> honesty and fairness permit consideration of the actual and normal business acumen of the seller. Here, the company could fairly deal with a person who had had many years of intimate acquaintance with the affairs of the corporation, who was closely related to many principals of the corporation, who had extrinsic sources of sound business advice, and who himself was promoting a speedy sale, in a manner that might not be fair if plaintiff had been a novice to stock transactions or the corporation's activities.
>
> On the one hand, corporate insiders must scrupulously disclose to outsiders *those material facts about a corporation's business which in reasonable and objective contemplation might affect the value of the corporation's stock or securities and which the insiders should reasonably believe are unknown to the outsider. On the other hand, they are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.*
>
> . . . .
>
> The statute and the rule basically call for fair play and abstention on the part of the corporate insider from taking unfair advantage of the uninformed outside or minority stockholder. Such a standard requires the insider to exercise reasonable and due diligence not only in ascertaining what is material as of the time of the transaction by disclosing fully *those material facts about which the outsider is presumably uninformed and which would, in reasonable anticipation, affect his judgment*.[550] (Emphasis added.)

These principles, as laid down in *Speed* and *Kohler*, were developed and confirmed in the judgments that followed. In *List v Fashion Park Inc*[551] the undisclosed facts List claimed had been material, were that one of the buyers of his stock was a director of Fashion Park and that the Fashion Park board, with a potential purchaser on the horizon, had resolved to sell or merge the company. The trial court had held that the plaintiff would have sold the shares even if he had known that one of the buyers was a director of Fashion Park and that, therefore, the

[549] Ibid. 638.
[550] Ibid. 637.
[551] 340 F 2d 457 (1965).

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undisclosed possibility that Fashion Park might be sold was not a material fact.[552] The court held:

> The basic test of "materiality," on the other hand, is whether a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question. . . . ["Materiality"] encompasses those facts "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities".[553]

The reasonable investor test has become firmly entrenched in United States law.[554] The *locus classicus* in United Sates federal law, in respect of the reasonable investor test and the definition of material information, is found in the judgment in *TSC Industries Inc v Northway Inc*.[555] The case dealt with materiality in proxy solicitation. However, the formulation of the materiality standard in that context was accepted in subsequent insider trading judgments.[556] United States courts, in applying the materiality standard in relation to inside information, use the following test:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to act . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available.[557]

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552 Ibid. 462.

553 Ibid.

554 *United States v O'Hagan* 139 F 3d 641 648 (8th Cir 1998) 648; *TSC Industries v Northway* 426 US 438 (1976) 449; *United States v Cusimano* 123 F 3d 83 (2d Cir 1997) 88–89.

555 *TSC Industries Inc v Northway Inc*. 426 US 438 (1976). See *Langevoort on insider trading* (Rel 7 4/2009) 5-3.

556 *Langevoort on insider trading* (Rel 7 4/2009) 5:3.

557 426 US 438 (1976). This case did not deal with insider trading, but was later held, in *Basic Inc. v Levinson* 485 US 224 (1998), to be applicable to insider trading cases. In *TSC* the court had to determine what was a material fact in the proxy-solicitation context. (The court rejected a previous test for material information formulated in *Mills v Electro Auto-Lite* 396 US 375 (1964) where it was said that: 'Where the misstatement or omission in a proxy statement has been shown to be "material", as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was

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In *Basic v Levinson*[558] the court had to consider the approach to be taken in a case of a merger, which was in itself an uncertain future event at the time of the trade. In the final analysis, held the court, materiality, whether it relates to an uncertain future event or any other type of fact, will depend on the reliance the reasonable investor would place on the information. It held as follows:

> Whether the merger discussions in any particular case are material therefore depends on the facts. Generally, in order to assess the probability that the event will occur, a factfinder will need to look to *indicia* of interest in the transaction at the highest corporate levels. Without attempting to catalogue all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as *indicia* of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value. No particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material.
>
> As we clarify here today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.[559]

The courts have made pronouncements about specificity and preciseness, but they are made within the context of this broader flexible test. In *SEC v Monarch Fund*[560] it was held that inside information must be specific and more precise than general rumour.[561] From its approach, it is apparent that the court viewed 'precise' as an antonym for uncertainty about truth. The specificity of a 'tip', it was also held in *Elkind v Ligget and Myers Inc,* is a factor in assessing its materiality.[562]

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of such a character that it *might* have been considered important by a reasonable shareholder who was in the process of deciding how to vote.'(Emphasis added.)

558 485 US 224 (1998) 232.

559 Ibid. 240.

560 608 F 2d 938 (2nd Cir 1979).

561 Ibid. 942–943. Also see *Elkind v Legitt and Myers Inc* 653 F 2d 156 (2d Cir 1980) 166–167.

562 See *Elkind v Ligget and Myers Inc* 653 F 2d 156 (2d Cir 1980).

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Other interesting and relevant issues, as they have come before the United States courts, include how to approach evidence of *ex post* trade price movements and false information. Evidence as to the actual movement of prices, through inside information being incorporated in them through trading, where that evidence is available, has not been universally accepted as a conclusive factor in the test for materiality. Rather, the movement in the price of a security when the information in question becomes public, has been held to be but one factor in determining materiality[563] or merely to support a finding of materiality.[564] The strongest holding about this was made in *United States v Carpenter*,[565] where it was held that once information has market impact, it is beyond question that the materiality standard is satisfied.[566] All this being said, the materiality standard developed as a standard quite independent from the requirement of a movement of prices.

The United States courts have been circumspect in establishing a firm principle on false inside information. In *Bateman Eichler, Hill Richards, Inc v Berner*[567] the court found that it had material before it that strongly suggested that certain information conveyed to the respondent investor before the court was true, but that the information was deceptive by virtue of exaggeration and the failure to include additional information.[568] The court reasoned as follows:

> If this was the case, and if the respondents otherwise acquired a derivative duty within the meaning of Dirks, there is no question that their trading on the basis of this information violated securities laws. If the information was entirely false, the SEC and Bateman Eichler contend that the respondents, by trading on what they believed was material non-public information, are nevertheless guilty of at least an attempted violation of the securities laws if they otherwise believed that Neadeau had breached his fiduciary duties. . . . The respondents, on the other hand, contend that they could not have inherited a duty to disclose false information, and that the case is properly

[563] *Rothberg v Rosenbloom* 771 F 2d 818 (3d Cir 1985). Also see *United States v Bilzarian* 926 F 2d 1285 (2d Cir 1991) and *Geiger v Solomon-Page Group Ltd* 933 F Supp 1180 (SD New York 1996) 1188.
[564] *SEC v Tome* 638 F Supp 596 (SD New York 1986) 623.
[565] 791 F 2d 1024 (2d Cir 1986).
[566] Ibid. 1042 footnote 9.
[567] 105 S Ct 2622 (1985).
[568] Ibid. 2629 and footnote 21.

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> viewed as governed by the doctrine of legal impossibility, which would bar any liability, rather than factual impossibility, which would permit liability on an attempt theory. . . . Because this issue has not been fully briefed and was not considered by the courts below, we express no views on it and simply proceed on the assumption that the respondents' activities rendered them in delicto.[569]

In *United States v Myllet*[570] the United States Court of Appeal for the Second Circuit, was equally careful not to make any holdings in relation to false inside information. It wrote:

> We do not today hold that any predictions made by an insider can constitute the basis for insider trading simply because a tippee relies upon them and their source, and they subsequently come true. It may well be that insider trading has not occurred, for example, in situations in which an insider has made categorical statements that are completely without foundation and these are used successfully by a trader. We need go nowhere near such an extreme holding, for here the statement made by the insider was qualified, supported and credible.[571]

SEC v Geon Industries[572] dealt with prima facie immaterial pieces of information communicated in a seemingly innocent manner. Geon Industries was engaged in the importation and distribution of repair and replacement parts for imported cars and trucks. Geon was founded, controlled and chaired by one Neuwirth. He was a co-defendant in the case together with the company's secretary-treasurer and financial vice-president, one Bloom. Geon Industries retained the services of Drexel Burnham & Co Inc to arrange discussions with a large British company, Burmah Oil Co, about a possible merger with it. After some preliminary discussions Burmah asked Geon for a forecast on the future of the automobile parts industry, five-year balance and income sheet estimates, and a cash flow projection. Accordingly, Bloom received instructions to provide Burmah with what they needed.

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[569] Ibid. 2629–2630 and footnote 21. (Also see M D Menghini "The Availability of the In Pari Delicto Defence in Tipee-Tipper Rule 10b-5 Actions after Dirks v SEC" (1984) 62 *Wash U LQ* 519 540–542.)
[570] 97 F 3d 663 (2nd Cir 1996).
[571] Ibid. 667. Also see *SEC v Thrasher* 152 F Supp 2d 291 (SD New York 2001) and *In re Motel 6 Securities Litigation* 161 F Supp 2d 227 (2001).
[572] 531 F 2d 39 (2d Cir 1976).

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Subsequently, Neuwirth and Bloom visited the British firm to further discussions. The meetings took place but nothing definite was agreed to between the parties.

Before leaving for England, Neuwirth met a friend and business associate, Alpert. In the words of the court, they met 'in the bar of a country club in Long Island, in accordance with a custom in which the Neuwirths and the Alperts would generally dine together on Wednesday nights'.[573] At the dinner Neuwirth told Alpert that he was going to London and said that he would be 'perhaps looking at some people in view of a merger'.[574] Alpert, who at that point owned only a few Geon shares, started to buy Geon. He bought shares until he held more than ten times what he did before the dinner.

As a result of the uncertainty about the negotiations, the court found that Geon did not have to disclose the merger to the SEC. However, the information about the state of the negotiations was found to be material inside information.[575] The *Geon* court also held that, when applying the materiality standard, a slightly different approach might be applicable to cases involving mergers and acquisitions:

> Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions — and this even though the mortality rate of mergers in such formative stages is doubtless high.

Difficulties also arise when some facts that relate to a specific event or subject are public while other facts are not. The defence will typically lead facts in an effort to show that all the information relevant to the trade was indeed public, while the prosecution will lead facts to show that the information in the public realm was not the information that actually afforded

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[573] *SEC v Geon Industries* 531 F 2d 39 (2d Cir 1976) 42.
[574] Ibid.
[575] Ibid. 47.

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the trader his unfair advantage. A good illustration of how the United States courts deal with this situation is found in the reasoning in the judgment of *Sec v Mayhew*.[576] The court wrote:

> In sum, the aggregate of public information prior to November 15, 1989, was to the effect that Roror was willing to merge if it found the right partner and that Rorer was discussing this possibility with up to three companies. Privately, Rorer executives took care to keep information about actual merger discussions secret by limiting the persons who knew about specific merger negotiations to top executives and by using codes in related documents.
>
> We agree with the district court that *the information Piccolino conveyed to Mayhew went beyond that which had been publicly disseminated*. Mayhew learned from Piccolino that [the president of Rorer's pharmaceuticals business] had confirmed that Rorer was "actually in discussions" towards a merger with a candidate or candidates. He also learned that these merger talks were at a "serious stage"— far enough along to warrant [Mayhew's company's] involvement in negotiating a new employment agreement for Rorer's CEO. To a reasonable investor, *this combination of new information, acquired privately, transformed the likelihood of a Rorer merger from one that was certainly possible at some future time to one that was highly probable quite soon.*[577] (Emphasis added.)

As to the non-public requirement, in *United States v Libera*[578] it was said that information may be considered public for Section 10(b) purposes even though there has been no public announcement and only a small number of people know it. The issue is not the number of people who possess the information but 'whether their trading has caused their possession to be fully impounded into the price of the particular stock'. At other times the courts have held that non-public information is, quite simply, information not generally available to the ordinary investing public.[579]

[576] 121 F 3d 44 (2d Cir 1996).
[577] *SEC v Mayhew* 121 F 3d 44 (2d Cir 1996) 50–51.
[578] *U.S. v Libera* 989 F 2d 596 (2d Cir. 1993).
[579] See *In re Investors Management Co Inc* 44 SEC 633 (1971) 643 and *Dirks v SEC* 463 US 646 (1983) 653.

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As to uncertain future events and how the materiality test is to be applied to them, it was said in *SEC v Texas Gulf Sulphur Co*,[580] that whether facts are material, depends at any given time upon a balancing of both the probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company's activities.[581]

3 3 2 Australia

The Australian courts and legislatures have to a certain degree vacillated between a flexible and open approach to inside information, and a highly prescriptive and detailed approach. At the same time they have allowed expert evidence to show whether the information in question would have influenced the market price of the relevant security at the time of the impugned trade.

The legal development in inside information properly started in *Commissioner for Corporate Affairs v Green*.[582] The Supreme Court of Victoria had to consider what constitutes information in this context. The facts were as follows. Green had been a director of two companies: Endeavour Oil Corporation NL (Endeavour) and Gwello Pty Ltd (Gwello). Gwello held shares in Endeavour.

The possibility of making a call on Gwello shares was discussed at an Endeavour directors' meeting. The discussions were preliminary and informal in nature. The matter had not been on the agenda and no resolution was taken to implement the idea. One of Endeavour's directors did, however, instruct an Australian share register company to draft and arrange for a call notice to be sent to the Melbourne Stock Exchange prior to the call being executed.

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[580] 401 F 2d 849 (1968) 849.
[581] *SEC v Texas Gulf Sulphur Co* 401 F 2d 833 (2d Cir 1968) 851.
[582] [1978] VR 505.

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Green was unaware of these arrangements. In the end, no final decision had been made to make the call, but a decision had been taken to discuss the matter further at a later stage.

The court dealt with the following provision in what was then section 124(2) of the Victorian Companies Act 1961:

> An officer of a corporation shall not make improper use of *information* acquired by virtue of his position as such officer to gain directly or indirectly an advantage for himself or for any other person or to cause detriment to the corporation.[583] (Emphasis added.)

Unrestricted by a legislative definition of 'information', the court had to give meaning to a much broader, less defined term than the one we find in our Act. The court reasoned as follows:

> In many cases a hint may suggest information or may enable an inference to be drawn as to information. Information about impending stock movements or share movements may often be veiled. Discussion concerning such a movement may often take the form of 'mooting' but not deciding a matter.[584]

The court therefore found that that which Green gained at the January 1975 board meeting was indeed information. Information was to be found in the mere fact that the board of directors had considered whether to make the call and that they had decided not to make that decision for the time being.[585] In coming to this conclusion, the court found that it was important that only a person familiar with and making a study of the movements of oil and mining shares might have deduced that a call would have been made in the future, detracting from the importance of the information. However, it held that it was of even greater significance that:

> the respondent had advance knowledge that not only was it likely, objectively speaking, that such a call would have to be considered but, in addition, he knew then what the

[583] Ibid. 510.
[584] Ibid. 511.
[585] Ibid.

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> outsiders did not know, namely, that the board had actually discussed the matter although it had decided to defer a decision for the time being.[586]

Green's information advantage lay not in his knowledge of a specific fact, but rather the fact that he knew with much greater certainty, to the exclusion of others in the market, that a call for Endeavour's shares was on the cards.

The court recognised that the information gave Green greater certainty about the trade than what a 'person familiar with and making a study of the movements' of the security in question, would have had.[587]

There were also judgments that evidenced a relatively conservative approach to the scope of the definition of inside information. In *Ryan v Triguboff*[588] it was held that the term 'specific information', where it was found in section 75A of the New South Wales Securities Industry Act of 1970, did not merely mean that the information had to be 'precisely definable', but that 'its entire content [had to be] precisely and unequivocally expressed and discerned'.[589]

In *Hooker Investments Pty Ltd v Baring Brothers Halkerston & Partners Securities Limited*[590] the meaning of information in section 128(1)[591] of the New South Wales Securities Industry Act 1980 was considered. The court struck out the plaintiff's claim and granted leave for the filing of a further statement of claim. In coming to its decision, the court reasoned as follows:

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586 Ibid.

587 Ibid.

588 [1976] 1 NSWLR 588.

589 Ibid. 596.

590 (1986) 10 ACLR 462.

591 That section reads:

> A person who is, or at any time in the preceding 6 months has been, connected with a body corporate shall not deal in any securities of that body corporate if by reason of his so being, or having been, connected with that body corporate he is in possession of information that is not generally available but, if it were, would be likely to materially to affect the price of those securities.

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> The next question is what is meant by "information"? In the *Ryan* case I referred to earlier and in the Canadian cases to which I made reference, information was held to be material which itself affected the price, not information which a person could use to make calculations. In Victoria in *Commissioner for Corporate Affairs v Green* . . . this line of reasoning was not followed and it seems to me that in view of the amendments made in 1980 that the definition given to information by McInerey J in that case comes close to what should be adopted here; that is, *the factual knowledge either of a concrete kind or that obtained by means of a hint or a veiled suggestion from which one can impute other knowledge*. I wonder a bit, however, whether it is safe to equate information and knowledge. Information is often defined as knowledge acquired, derived or inculcated by observation, reading or study or by what one is told; but in some cases information implies lack of knowledge such as, for instance, where one says he is informed of a thing but he does not know whether or not his information is true: see State v Simpson 118 SW 1187 at 1188.
>
> To my mind information in subsection (1) goes further than knowledge and includes the situation where someone has been informed of something which he does not know to be true nor does he care whether it is true or not. In other words, information may include a rumour that something has happened with respect to a company which a person neither believes or disbelieves.[592]

As will become apparent, the Australian legislature has, in the legislation currently in force, included specific provisions relating to matters of supposition and deduction.[593] In the 1970 Securities Industry Act no reference was specifically made to these matters. The Act simply prohibited persons associated with a corporation who had 'knowledge of specific information relating to the information'.[594] It was in issue before a New South Wales court whether a deduction formed by a defendant accused of insider trading could be regarded as specific information?[595] The court held that it could not. It held that a deduction did not constitute specific information. That phrase, held the court, required information that was capable of

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[592] *Hooker Investments Pty Ltd v Baring Brothers Halkerston & Partners Securities Limited* (1986) 10 ACLR 462 467–468.

[593] See p. 165 below.

[594] As quoted in *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963 par. 527.

[595] *Ryan v Triguboff* [1976] 1 NSWLR 588.

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being pointed at, identified and 'capable of being expressed unequivocally'.[596] Deductions have now been included in the Australian definition of inside information.

The Corporations Legislation Amendment Act 1991 of Australia presented a paradigm shift in Australian insider trading regulation. It, among other things, contained a new definition of what was to be understood under the term 'information' in relation to insider trading.[597] This definition is also contained in the Australian insider trading provisions currently in force, to be found in section 1042A of the Corporations Act. In dealing with the proposed Amendment, the Explanatory Memorandum to the Corporations Legislation Amendment Bill 1991 provides as follows:[598]

> Doubt was also expressed as to whether the term 'information' would be interpreted as encompassing supposition, intentions and other matter sufficiently certain to require its release to the public, notwithstanding the broad interpretation given to the term in *Commissioner for Corporate Affairs v Green* [1978] VR 505 at 511.

The new definition[599] provided that information also includes matters of supposition and other matters that are insufficiently definite to warrant being made known to the public, including matters relating to the intentions or likely intentions of the parties.[600]

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596 Ibid. 597. Also *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963 par. 528.

597 See p. 165 below.

598 Also quoted in *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963 par. 532.

599 The new definition was contained in section 1002A(1) of the Australian Corporations Act but was later retained in section 1042A.

600 The explanatory memorandum to the Corporation Legislation Amendment Bill (which became the Australian Corporations Amendment Act 1991) reads:

> Doubts was also expressed as to whether the term 'information' would be interpreted as encompassing supposition, intentions and other matter not sufficiently certain to require its release to the public, notwithstanding the broad interpretation given to the term in Commissioner for Corporate Affairs v Green [1978] VicRp 48; [1978] VR. 505 at 511.
>
> *Proposed amendment*

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'Inside information' is now defined in the Australian Corporations Act as meaning:

> information in relation to which the following paragraphs are satisfied:
> (a) the information is not generally available;
> (b) if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products.[601]

The Act further defines 'information', 'generally available', and 'material effect'.

> '[I]nformation' is:
>
> (a) matters of supposition and other matters that are insufficiently definite to warrant being made known to the public; and
> (b) matters relating to intentions, or likely intentions, of a person.[602]

'Generally available' is defined as:

> (1) For the purposes of this Division, information is generally available if:
> (a) it consists of readily observable matter; or
> (b) both of the following subparagraphs apply:
> (i) it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in Division 3 financial products of a kind whose price might be affected by the information; and
> (ii) since it was made known, a reasonable period for it to be disseminated among such persons has elapsed; or
> (c) it consists of deductions, conclusions or inferences made or drawn from either or both of the following:
> (i) information referred to in paragraph (a);
> (ii) information made known as mentioned in subparagraph (b)(i).

Proposed section 1002A(1) provides definitions of 'information' and 'securities', in relation to a body corporate, to apply for the purposes of the insider trading provisions. The definition of information is an inclusive one, with information being taken to include supposition and other matters insufficiently definite to warrant being made known to the public and matters relating to the intentions, or likely intentions, of a person. (319–320).

[601] Section 1042A of the Australian Corporations Act.

[602] Section 1042A of the Australian Corporations Act.

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Section 1042D of the Australian Corporations Act also expressly sets out when a reasonable person would take information to have a material effect on the price or value of financial products. It provides:

> For the purposes of this Division, a reasonable person would be taken to expect information to have a material effect on the price or value of particular Division 3 financial products if (and only if) the information would, or would be likely to, influence persons who commonly acquire Division 3 financial products in deciding whether or not to acquire or dispose of the first-mentioned financial products.[603]

The Australian courts have as yet only to a limited extent considered the sections. In *R v Bateson*,[604] it was held that the provisions allow for expert evidence to be led about whether the information in question could at the time of trading have been expected to have a material effect on the price of the shares.[605]

In *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)*[606] the court expressed its views on the definition of information in section 1042A. According to the court, even if information is non-specific, what is drawn from it by way of inference may be regarded as information in terms of the section.[607] The court held that information can be communicated orally or by conduct — by the 'observation of the words or conduct of others'.[608] A supposition would, according to the court, be that which a person draws from the hint or other non-specific information received from another.[609] Although a hint or other non-specific information must be communicated by words or conduct, the inference or supposition drawn from it would qualify as information.[610] The kind of information that may affect the securities market may be imprecise, but if the information is

603 Section 1042A read with section 1042D of the Australian Corporations Act.
604 [2011] NSWSC 643.
605 *R v Bateson* [2011] NSWSC 643 par. 5(G).
606 [2007] FCA 963 par. 526–544. Also see p. 292 below.
607 Ibid. par. 537.
608 Ibid.
609 Ibid. par. 538.
610 Ibid. par. 542.

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so imprecise that it is unlikely to affect the market, a charge of insider trading in relation to the information cannot be made out.[611] The court had to assess a supposition.[612]

A trader in Citigroup's equity derivatives division had been trading heavily in the shares of a company that Citigroup's investment banking division were advising about a takeover, Toll Holdings Limited (Toll). When he came to know of this, the trader's senior called him away from the trading desk. Manchee, the trader, was asked how many shares he had purchased; why he had purchased them; and why he was being so aggressive in trading in Patrick stock. He replied that his actions were informed by hedge fund trading, charts, volume and rumours from outside the company. He was instructed to cease trading in Patrick stock. He however went back to his workstation and sold some of the Patrick shares. The day after, Toll's bid for Patrick was announced.

The court undertook an analysis of 'Mr Manchee's thought process'.[613] It found that Manchee had perceived the discussion with his superior as unusual. His testimony was that he had sold the 200 000 shares because he thought his senior had meant that he was carrying too much

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611 Ibid. par. 543.

612 Ibid. par. 526. At the time of the decision, the Australian insider trading provisions did not contain an express reference to supposition. The definition of 'inside information' then read:

> inside information means information in relation to which the following paragraphs are satisfied:
> (a) the information is not generally available;
> (b) if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of [certain] financial products.

(See *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963 par. 247.)

The term 'material affect' was defined as follows: 'material effect, in relation to a reasonable person's expectations of the effect of information on the price or value of [certain] financial products, has the meaning given by section 1042D'.

Section 1042D provides as follows: 'For the purposes of this division, a reasonable person would be taken to expect information to have a material effect on the price or value of particular . . . financial products if (and only if) the information would, or would be likely to, influence persons who commonly acquire [certain] financial products in deciding whether or not to acquire or dispose of the first mentioned financial products'.

613 *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963 par. 57.

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risk. When he was pressed about whether he supposed that 'when he was telling you to stop buying it had something to do with these rumours about a Toll takeover?' Manchee replied, 'I probably assumed it did'.[614] Manchee further testified that he might have thought that there was something that his superior could not tell him in relation to the Toll takeover. Indeed, he stated:

> Perhaps at the time I thought he might have known something he couldn't tell me, and the reason that he would know something but couldn't tell me that Citigroup were involved somehow, perhaps he would have known, and I might have thought about that as a possibility.[615]

The allegation was that the inside information acted on was a supposition made by Manchee during the conversation when he was pulled away from his trading desk.[616] The court had to decide whether any supposition was made by Manchee and, if indeed he supposed anything, what it was.[617] As required by the wording of the Australian provisions, the court, however, first had to determine whether Manchee could be regarded as an officer of Citigroup, for only the knowledge of 'officers' are attributable to a corporation.[618] The court found him not to be an officer, and therefore his knowledge not to be attributable to the corporation.

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614 Ibid. par. 58.
615 Ibid. par. 59.
616 Ibid. par. 466.
617 Ibid. par. 467.
618 Section 1042G(1) of the Australian Corporations Act provides in relevant part:

> For the purposes of the insider trading provisions:
> (a) a body corporate is taken to possess any information which an officer of the body corporate possesses and which came into his or her possession in the course of the performance of duties as such an officer; and
> (b) if an officer of a body corporate knows any matter or thing because he or she is an officer of the body corporate, it is to be presumed that the body corporate knows that matter or thing; and
> (c) if an officer of a body corporate, in that capacity, is reckless as to a circumstance or result, it is to be presumed that the body corporate is reckless to that circumstance or result.

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In *Hannes v Director of Public Prosecutions* (Cth) (No 2)[619] the court reasoned that the defined term 'information' in section 1002A(1) of the Australian Act is inclusive rather than comprehensive, but that it expressly includes 'matters relating to the intentions, or the likely intentions, of a person'. Further, according to the court, the intention of natural persons or a corporation may be held with 'varying degrees of certainty'.[620] The court wrote as follows:

> The existence of such an intention is information. If it is passed on to others, it is information in the hands of the recipients. However, the intention may be inferred by others from the conduct of the directors. The inference may be drawn with varying degrees of certainty as to its accuracy. Nevertheless, such an inference remains information. Indeed, there is no clear distinction between information conveyed orally and by conduct. In the case where the director tells a third party of his or her intentions, the information is in fact inferred not merely from receiving the communication, but from a belief as to its veracity.[621]

The court agreed with the reasoning of McInerney J in *Commissioner for Corporate Affairs v Green*, where it was held that the kind of information that may affect a securities market may be 'quite imprecise'. The court qualified this statement by holding that:

> The source of the rumour may be of very considerable importance, despite the vagueness of the known details. If the information in question is so imprecise that it is not likely to affect the market, the charge will not be made out. But if it is sufficient to satisfy the element of the offence, there is no reason to import into the statutory definition an additional requirement of specificity or precision.[622]

The Australian courts have also had occasion to tentatively address false inside information and whether such a concept exists. In the unreported New South Wales Supreme Court decision of *R v Rivkin*[623] a charge of insider trading under section 1002G of the Australian Corporations Act had been laid. The accused argued that the indictment, together with the particulars, disclosed no breach of the insider trading provisions as the 'information' relied

[619] [2006] NSWCCA 373.
[620] Ibid. 411.
[621] Ibid.
[622] Ibid. 416.
[623] Case 70065 of 2002 (NSWSC) 10 April 2003.

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upon by the prosecution was not 'information' as that term is defined in section 1002A of the Australian Act. The court held that a falsehood may fall within the definition of information. It reasoned as follows:

> While it is not necessary for me to express a concluded opinion, nor indeed is it desirable to do so for purposes of the present application, I must say that I incline to the tentative view that a statement as to the existence of a state of affairs – even though it may not be precisely accurate at all – may nevertheless be comprehended within the concept of information for the purposes of the insider trading legislation. That is, information which is confidential, price sensitive and which may not be used in the prohibited manner may nevertheless extend to inaccurate or even baseless information."

In *R v Mansfield*[624] Messrs Mansfield and Kizon were prosecuted for various offences as provided for by the insider trading provisions found in the Australian Corporations Act 2001. The inside information in the case related to two publicly listed companies, My Casino Limited (My Casino) and a company called Adultshop.com Limited (Adultshop). The information consisted of statements that the prosecution alleged was made by either a managing director of Adultshop or a chairman of My Casino.

After the prosecution presented its case, the defendants applied for absolution from the instance.[625] They based their application, inter alia, on the fact that the evidence adduced by the prosecution, taken at its highest, would not have been able to satisfy the jury beyond a reasonable doubt that the information relied upon for some of the charges was 'factually correct.' The issue the court had to determine was whether it was a necessary element of the offences in the Australian insider trading provisions that inside information be 'truthful' or a 'factual reality'. In other words, must the inside information be true? Or, conversely, can a falsity be regarded as information?

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[624] [2011] WASCA 132.

[625] The defendants made application pursuant to section 108 of the Australian Criminal Procedure Act 2004, which is akin to the South African application for absolution.

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When the court's analysis is assessed, two characteristics of Australian insider trading regulation must be kept in mind. Firstly, the Australian provisions do not require an insider to be connected in any way to the company to which the information relates.[626] The ambit of the prohibitions is thus not circumscribed by a definition of insider. It is circumscribed, apart from the defences provided by the Act, only by the definition of inside information. Consequently, the definition of inside information in Australian legislation stands alone in curbing the ambit of the prohibitions.

In support of the proposition that falsehoods cannot form part of information, it was argued that the Australian legislature could never have intended that falsehoods or lies could warrant being made known to the public, unless they were accompanied by information exposing their falsity. If it were not so, the publication would lead to market distortion and unfairness. The publication of a false statement would, so it was submitted, distort the market and lead to the very consequences the market manipulation provisions of the Australian Act were meant to address.[627] It was further argued that the notion of equal access to information cannot be thought to include false statements.[628]

Buss JA, after interpreting the legislation in question, held that:

> (a) a statement may be 'information', as defined, irrespective of whether or not the matters stated are reliable or have a sound factual foundation;
> (b) an opinion, a prediction and a forecast may each be 'information', as defined, irrespective of whether or not there are reasonable grounds for the opinion, prediction or forecast; and
> (c) a statement, opinion, prediction and forecast may each be 'information', as defined, even if the person who makes or repeats the statement, opinion, prediction or forecast knows or believes that:
> (i) it is unreliable or has an unsound factual basis; or
> (ii) it is not based on any reasonable grounds; or

[626] See p. 302 et seq. below.
[627] *R v Mansfield* [2011] WASCA 132 par. 43.
[628] Ibid. par. 44.

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(iii) it is unreasonable, false or a lie.[629]

Buss JA's reasons for endorsing this broad definition of information were, apart from those connected to his contextual legislative interpretation,[630] the following. According to the judge, information that involves the expression of an opinion or a prediction, including opinions and predictions that are not based on reasonable grounds, are inherently uncertain, imprecise or speculative, at least to a certain degree.[631] In effect, the court reasoned that should one exclude an untruthful statement, as the line between it and opinions and predictions are so fine, one would have to exclude opinions and predictions as well. The court held that:

> [T]he inclusion within 'information', as defined, of information that is not 'truthful' or not a 'factual reality' or not based on reasonable grounds is consistent with the market fairness policy rationale, and significant aspects of the market efficiency policy rationale, on which the [Australian] insider trading prohibitions are based. It is consistent with the market fairness rationale in that a person who trades in securities while in possession of inside information (whether or not the information is 'truthful' or a 'factual reality' or based on reasonable grounds) will have information that is not available to the persons with whom he or she is dealing. It is consistent with significant aspects of the market efficiency rationale that a person who trades in securities while in possession of inside information (whether or not that information is 'truthful' or a 'factual reality' or based on reasonable grounds) is engaging in conduct of a kind which is likely to diminish the investing public's confidence in the securities market.[632]

Buss JA held that there was no difficulty in conceptualising how untruthful information could satisfy the test of materiality. In the Australian provisions, materiality must be found in that a reasonable person would expect the information to have a material effect on the price or value of shares to which the information relates. This evaluation would, according to Buss JA, be based on:

[629] Ibid. par. 114

[630] As is clear from the definition provided above, the Australian Corporations Act has an extremely broad definition of 'information'. This broad definition influenced Buss JA's findings on whether information should be truthful.

[631] Ibid. par. 118.

[632] Ibid. par. 125.

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> (a) what is reasonably embodied in or conveyed by the relevant statements of alleged fact, opinions, predictions, forecasts, statements of intention or likely intention hypotheses, assumptions, hints, suggestions or conjecture etc, as the case may be; and
> (b) the identity of the person who generated or allegedly generated the matters,
> in the context of any other information which is (in contrast to the alleged inside information) generally available and which is relevant to the price or value of the . . . financial products in question.[633]

Murray J, in concurring with Buss JA in his holding that information need not be true for a successful prosecution of an insider trading offence, found there to be no policy considerations underlying the Australian provisions, or any legislative contextual arguments, which required a rule that inside information be true. In the judge's view, information is:

> (1) Something which is communicated by words or deeds. Paragraph (a) of the definition shows that it may include matters of supposition, i.e., matters in respect of which information is conveyed by inference from statements made or conduct.
> (2) To be information, the thing communicated must concern a matter of fact. Paragraph (b) of the definition says that 'information; includes matters relating to the intentions or likely intentions of a person. A person's intention is, of course, a matter of fact.[634]

The judge found no policy basis or a reason arising out of the meaning of the word 'information', which presupposed that a 'factual communication' ceases to be information because that communication is false or an invention. In other words, '[t]he fact that information is untrue does not cause it to cease to be information'.[635]

The judge made further interesting observations on what amounts to inside information. He held that information in the context of the insider trading provisions could, at once, be a

[633] Ibid. par. 130.
[634] Ibid. par. 307.
[635] Ibid. par. 308.

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statement about the source of the information as well as a statement about that which was said.[636] In other words, the information could relate to the one who made the statement: It was Mr X who said Y. And, the information could relate to the substance of the statement: Y. In addition, the 'information may be price-sensitive, not only because of its nature, but also because of the source connected with the company concerned from which the information was said to be derived'.[637]

McLure P did not agree with Buss JA and Murray J, that inside information need not be a factual reality for a successful prosecution. His point of departure is that the Australian Corporations Act includes a wide definition of inside information.[638] The Judge held that the word 'information', in both its natural and extended meanings, includes hearsay.[639] As is clear from the Act, it also includes matters of opinion, actual or likely intention, and assumption. Therefore, the judge held that it was clearly implicated in the Australian legislation that information is connected with a person or entity.[640] The Australian legislature's intention[641] is that inside information had still to originate as confidential information in possession of an entity entitled to act on it or have it. Inside information must actually exist. Something would not be inside information merely because a real insider communicated it to an accused.

The judge held further that in order to establish that an accused is in possession of inside information for the purposes of the Australian section 1043A(1), there must be, although not necessarily 'coextensive', a 'proven correlation or correspondence' between the inside

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[636] Ibid. par. 309.
[637] Ibid. par. 311.
[638] Section 1042A of the Australian Corporations Act defines 'inside information' to include:
> (a) matters of supposition and other matters that are insufficiently definite to warrant being made known to the public; and
> (b) matters relating to the intentions, or likely intentions, of a person.

[639] *R v Mansfield* [2011] WASCA 132 par. 10.
[640] Ibid. par. 10.
[641] The judge deduced this 'evident statutory intention' from the definitions of 'information' and 'inside information' in the Australian Act.

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information in the accused's possession and that in possession of the entity. Of course, the judge reasoned, inside information may the product of inferences, deductions or assumptions made by the accused, but that these inferences, deductions or assumptions in the accused's possession must be based on inside information relating to 'actual events or information' from within the entity entitled to use that information. These inferences and deductions can, according to the judge, be wrong or misleading even if they were to be based on inside information.[642]

He held that an accused will be found to be in possession of inside information only if it is proven that that inside information corresponds, at least in part, with the actual internal affairs or internal workings of the entity entitled to possess it. For instance, if it is alleged that the information was based on the reception of a rumour of what an officer of the company was said to have reported to the company's board, the prosecution had to prove the existence of the rumour. It does not have to prove the truth of the rumour.[643] In the same manner, held McLure P, if the rumour contained a prediction, opinion or intention, it would not be necessary for the prosecution to prove that there were reasonable grounds for the prediction, opinion or intention.[644] In the final analysis, McLure P found that, as the evidence adduced by the prosecution was incapable of supporting a finding that the information was based on

[642] *R v Mansfield* [2011] WASCA 132 par. 15.

[643] *R v Mansfield* [2011] WASCA 132 par. 16. In summary, McLure P held as follows:
'... it is an element of the offence of insider trading that the inside information in the possession of the accused correspondent in material part with actual inside information in the possession of the entity entitled to have used it. Thus, a fraudulent misrepresentation as to the internal affairs of the entity, even if made by an officer thereof, is incapable of being inside information.' The learned Judge held further that his 'construction of the expression "inside information" is consistent with the statutory purposes of the insider trading provisions of the [Australian] Act, being to ensure market efficiency and market fairness, in the sense that all parties to a transaction have the opportunity to access the same information. It is also consistent with the 1989 Griffiths Report (Fair Shares For All, Insider Trading in Australia) on which the current statutory scheme is based. The Griffiths Report concluded:
'The offence of insider trading must have its genesis in the use of information derived from within the company [4.3.5].'

[644] *R v Mansfield* [2011] WASCA 132 par. 16.

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information 'in the possession of the bodies corporate whose shares were traded', the appeal had to be dismissed.[645]

As to the Australian Corporations Act's requirement that the information must be 'not generally available',[646] the Australian courts have held that it is a question of fact whether a matter is 'readily observable' or not. It has an objective, hypothetical test. Whether information is readily observable will, according to the courts, not depend on whether people have actually perceived the information. The test is rather one that asks: has the particular information been 'widely observed'.[647] Where a court considers general availability in relation to suppositions, the court asks whether other investors would have been able to make the

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[645] Ibid. par. 21.

[646] See section 1043A of the Australian Corporations Act.

[647] *R v Mansfield* 2011 WASCA 132 par 147. Buss JA, relied on a dictum of Mason P in the *R v Firns* (2001) 38 ACSR 223. At par. 87–89 Mason P held as follows:

> I have endeavored to show why, in my opinion, a decision that a particular item of information is 'readily observable matter' is a complex and nuanced one that takes into account the international ambit of Division 2A and the capacity for types of information to be relayed across the world instantaneously through modern means of telecommunications.
>
> As indicated already, the issues are par excellence a jury question [a question relating to fact], especially bearing in mind the presence of the 'readily' in the statutory definition. This said there are some categories of information which by their nature and the circumstances of their revelation are inherently observable and readily so. Observability does not depend upon proof that a person. or group of persons, actually perceived the information. That is not to say that the depositing of information in an obscure portion of a public library would establish *ready* observability. The issue is factual or one for the jury. But the point of present relevance is that the objective and hypothetical circumstances are to be looked at, not merely the actualities in the particular case. Ready observability cannot be located a priori in the Australian capital cities where the ASX has a physical presence.
>
> In some cases the matter may be so clear that a court could determine that there was no evidence capable of grounding a conviction based upon proving the negative proposition that the information used by the insider was not 'readily observable matter'. In other situations, there would be evidence fit to go to the jury but the Crown case would be so weak that any conviction would be unreasonable in the sense expounded in *Jones v The Queen* (1997) 191 CLR 439. Thirdly, an appellate court considering whether to direct a new trial would have regard to the sufficiency of the evidence to bring about a verdict that would not be unreasonable.

Also see *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963 par. 546 and 551.

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supposition from readily observable matter or information that had been generally known.[648] The Australian Corporations Act also does not require a consideration of whether the market has had a reasonable time to absorb the information in question when it comes to matters of deduction, conclusion or inference.[649] Jacobson J in ASIC reasons that this is the case as the Australian legislature did not want to 'penalise individual initiative and diligence'.[650]

A further interesting example emanating from the Australian courts is that of *R v Hartman*[651]. The case makes clear that, in Australia, inside information does not necessarily have to relate to the securities in question themselves, but could be information relating to a subject distinct from the security in question, such as information about trading in those securities. Hartman pleaded guilty to insider trading and tipping offences contained in the Australian Act.[652] Hartman had bought and sold contracts for difference in shares (CFDs) of an entity while in possession of inside information obtained during his employment.

His offences related to what is commonly known as 'front running'.[653] Front running occurs when a person, typically a trader who is aware of a pending offer for shares, trades in the share or its derivative prior to the execution of the order.[654] Typically, he trader trades shortly after

[648] *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963 par. 547.

[649] Australian Corporations Act section 1042C(1)(c). ASIC at par. 552. Also see the analysis of the extrinsic evidence in the case of *R v Firns* (2001) 38 ACSR 223 par. 55–56.

[650] This quote from *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963 was in turn quoted from the judgment of Mason P in *R v Firns* (2001) 38 ACSR 223.

[651] 2010 NSWSC 1422. The sentence imposed in Hartman was taken on appeal. The judgment in the appeal is reported at *Hartman v R* [2011] NSWCCA 261.

[652] See sections 1043A(1) and 1043A(2) of the Australian Corporations Act 2001.

[653] *R v Hartman* 2010 NSWSC 1422.

[654] Ibid. par. 1.

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the offer is made, with the intention to take advantage of an anticipated rise or fall in the share price. [655]

Hartman worked for Orion Asset Management Limited.[656] He was employed as an equities dealer and, as such, had the mandate to buy and sell securities listed on the Australian Securities Exchange. He did so according to instructions provided to him by Orion's stock portfolio managers. The securities were bought and sold by Orion as a fund manager on behalf of its clients.[657] The number of securities held by Orion in any particular security was determined by Orion's portfolio managers. They set targets for the acquisition or disposal of specific stocks in order for Orion to maintain the best possible portfolio on behalf of its clients. The company's 'target portfolio weights' determined the desired level of acquisition or disposal of particular securities.[658] Hartman's role at Orion involved buying and selling shares to align the target and actual weights of shares held on behalf of Orion's clients. The target portfolio weights for each of Orion's investment options were recorded by Orion's portfolio managers in an electronic spreadsheet linked to Orion's trading system. Using this system, Hartman was able to see the difference between the target quantity and the actual quantity of shares held on behalf of Orion's clients.[659] Hartman was also able to monitor the general level of trading in particular shares, while monitoring the execution of orders that he had previously placed with brokers.

To reach the portfolio targets, Orion's trading would often involve buying and selling significant volumes of particular companies' shares. These purchases, as Hartman came to realise, had the effect of raising and lowering the price of a stock within a short time frame.[660] Hartman thus began to trade in CFDs. CFDs' value, as they are derivative securities, is

[655] Ibid.
[656] Ibid. par. 9.
[657] Ibid.
[658] Ibid.
[659] Ibid.
[660] Ibid.

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determined by the price of an underlying share. Trading in CFDs, like trading in all derivatives, is to be distinguished from trading in equity. The CFD trader has to pay only a margin, usually around 10%, of the total value of the underlying value of the share. When a CFD is sold, the CFD trader does not have to acquire the underlying shares for transfer to the purchaser at settlement.[661] Once a CFD's position is opened, it can be held open for as long as a trader wishes.[662]

Buying or selling CFDs is economically similar to buying or selling the underlying security on the stock market in that, firstly, the perceived price at which the CFD is traded is the same price the underlying share is traded for on the stock market. Secondly, the CFD trader, when a CFD is bought, receives the benefit of all the increases and bears the cost of all the decreases in the price of the underlying share. On the other hand, when the CFD is sold, the trader receives the benefit of all the increases and bears the cost of all the rises in the price of the underlying share. Third, commission or brokerage is paid on the trading. Fourth, the CFD trader's account is credited with an amount equal to any cash dividend paid on the underlying share.[663] As a result, investing in CFDs is high-risk, high-reward. The potential profits gained or losses incurred in CFD trading are much greater than trading in the underlying instruments.[664] The trader pays approximately 10% of the total value of the CFDs he acquires, but receives either the total benefit (or the loss) resulting from the sale of the underlying securities.

A 'buy CFD' on an individual share is purchased when a person expects the share price to rise. What Hartman did, was to buy CFDs in connection with the particular share at a time when he was directed by Orion's target portfolio weights to purchase those shares. A 'sell CFD' on a specific share, on the other hand, is bought when a person expects the share price to fall.

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661 Ibid.
662 Ibid.
663 Ibid.
664 Ibid.

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Accordingly, Hartman traded in sell CFDs in the shares that Orion's target portfolio weights indicated had to be sold.[665] He would open CFD contracts in the shares of the entity to which the information related. He would then place his orders to buy or sell as dictated by the target portfolio weights. Not only was Hartman throughout aware of the approximate quantity and directions of the securities traded, he also knew how much of the order was completed or outstanding at any time. Once the buying or selling in a particular share on behalf of Orion was approaching completion, Hartman would close out his CFD position by placing an opposing trade on his personal account.[666]

Hartman also admitted to having passed information to Curtis.[667] Hartman and Curtis were best friends and worked in the same industry.[668] Curtis let Hartman know whether he had traded in the CFDs or was unable to trade.[669] This indicated to Hartman when to start trading on behalf of Orion in the shares in which Curtis had taken a CFD position. Once Hartman was sure that his trading on behalf of Orion was nearing completion, he would send Curtis another message telling him to sell or 'get out' of the entity's CFDs in which they were trading.[670]

The inside information, found the court, was the information that Orion intended to purchase or sell a large number of particular securities on the Australian Stock Exchange and, in relation to Curtis, that Hartman himself would control the conduct and monitor the order.[671]

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665 Ibid.
666 Ibid.
667 Ibid. par. 21.
668 Ibid. par. 22.
669 Ibid. par. 28.
670 Ibid. par. 30.
671 Ibid. par. 16.

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3 3 3 European Union

Much like in Australia,[672] the European Union began with a relatively broad and flexible definition of inside information. It has recently, however, started on a reactionary course. It is adding layers to its definition of inside information almost, it seems, as a result of every relevant European Court of Justice judgment.[673]

When a commission of the European Community first started deliberating a possible insider trading directive in 1976, only France had enacted a prohibition against insider trading. That prohibition was rarely, if ever, enforced.[674] Prior to the 1980s, securities regulation in the European Union, outside Great Britain, was virtually non-existent.[675] In 1989 the Council of the European Communities issued a directive coordinating regulations on insider dealing.[676] The directive recognised that a fluid secondary market in transferable securities played an important role in financing economic agents. It further recognised that for the market to operate efficiently, it had to inspire confidence in investors. The factors on which that confidence depends, it recognised, 'include the assurance afforded to investors that they are placed on an equal footing and that they will be protected against the use of inside

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[672] See p. 159 et seq.

[673] See p. 183 et seq.

[674] M G Warren "The Regulation of insider trading in the European Community" (1991) 48 *Washington and Lee Law Review* 1037 1040.

[675] Warren (1991) *Washington and Lee Law review* 1040.

[676] Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing ('1989 Directive'). For discussion of the 1989 Directive see T L Hazen "Defining illegal insider trading – Lessons from the EEC Directive on Insider Trading" (1992) 55 *Law & Contemp Probs* 231; R Fornasier "The Directive on Insider Dealing" (1990) 13 *Fordham Int'l LJ* 149; Z J Winner "A Comparative Analysis of the European Community's Insider Trading Directive" (1990) 3 *Trans L* 231.

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information'.[677] By benefiting only certain investors, insider dealing was said to be likely to undermine that confidence.[678]

The preamble to the 1989 Directive promised that its focus was on trading on inside information,[679] but in actual fact it employed a misappropriation approach.[680] It did recognise that insider trading essentially involves the 'taking advantage of inside information'.[681] The Directive defined inside information simply as 'information which has not been made public, of a precise nature relating to one or several issuers of transferable securities or to one or several transferable securities, which, if it were made public, would be likely to have a significant effect on the price of the transferable security or securities in question'.[682]

The Council of the European Communities Directive 2003/6/EC of the European Parliament and of 28 January 2003 on insider dealing and market manipulation (market abuse) (2003

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677 See the preamble to the 1989 Directive.

678 Ibid.

679 The preamble provided that 'the secondary market in transferable securities plays an important role in the financing of economic agents' and that 'for the market to play its role effectively', every measure should be taken for it to operate 'smoothly'. The smooth operation of the market was, in turn, said to depend 'to a large extent on the confidence it inspires in investors' and that 'the factors on which such confidence depends include the assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information'. It went further to state that 'by benefiting certain investors' as opposed to others, 'insider dealing is likely to undermine that confidence and may therefore prejudice the smooth operation of the market'.

680 Article 2(1) of the Directive read:

> Each Member State shall prohibit any person who:
> - by virtue of his membership of the administrative, management or supervisory bodies of the issuer,
> - by virtue of his holding in the capital of the issuer, or
>
> because he has access to such information by virtue of his exercise of his employment, profession or duties,
>
> possesses information from taking advantage of that information with full knowledge of the facts by acquiring or disposing of for his own account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which the information relates.

681 Preamble to the 1989 Directive.

682 Article 1(1) of the 1989 Directive.

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Directive) replaced the 1989 Directive.[683] The 2003 Directive defined inside information, also with relative brevity, as follows:

> Inside information is any information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments. Information which could have a significant effect on the evolution and forming of the prices of a regulated market as such could be considered as information which indirectly relates to one or more issuers of financial instruments or to one or more related derivative financial instruments.[684]

The Commission of the European Communities Directive 2003/124/EC of 22 December 2003, that implemented the 2003 Directive, further defined the concepts of precise and public inside information. Information was to be deemed to be of a precise nature if, firstly, it indicated a set of circumstances that existed or may reasonably have been expected to come into existence, or an event had occurred or may reasonably have been expected to have occurred. Secondly, it was specific enough to enable a conclusion to be drawn about the possible effect of the set of circumstances or event on the prices of financial instruments or related derivative financial instruments.[685] Information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments or related derivative financial instruments, was defined as information that a reasonable investor would be likely to use as part of the basis of his investment decisions.[686]

These definitions have recently been substantially amended. The amendments were brought about by the cases of *Spectar Photo Group NV*,[687] *Getl v Daimler AG*[688] and *Lafonta v ANF*.[689]

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683 Preamble to the Council of the European Communities Directive 2003/6/EC of the European Parliament and of 28 January 2003 on insider dealing and market manipulation (market abuse) par. 13 and article 20.

684 Preamble to the 2003 Directive par. 16.

685 Article (1) point 1 of the December 2003 Directive.

686 Article (1) point 2 of the December 2003 Directive.

687 [2009] EUECJ C – 45/08 (23 December 2009).

688 [2012] EUECLI C – 19/11 (28 June 2012).

689 [2015] EUECLI C – 634/13 (11 March 2015).

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In *Spectar Photo*, the European Court of Justice was approached by the Belgian Hof van Beroep te Brussel for a preliminary ruling. One of the questions the court was asked to answer was when the disclosure of inside information must be deemed to have influenced the price of a financial instrument and, if that is found, what the threshold is at which that influence should be regarded as significant.[690]

The court noted that the capacity of information to have a significant effect on the price of financial instruments to which it relates, is one of the characteristic elements of the concept of inside information.[691] In accordance with the objectives of the 2003 Directive, held the court, that capacity must be assessed in the light of the content of the information at issue and the context in which it occurred. It is not necessary, in order to determine whether information is inside information, to examine whether its disclosure actually had a significant effect on the price of the financial instruments to which it relates.[692] The investigation is a hypothetical one, rather than an actual one, done at the time of the trade.

In *Getl v Daimler AG,*[693] following Daimler AG's annual meeting on 6 April 2005, Mr Schrempp, Chairman of the Board of Management, began to consider resigning his appointment before 2008, the year set for his retirement. He first conveyed this to his wife, who was the manager in charge of his office.[694] On 17 May 2005, Mr Schrempp also informed the chairman of Daimler AG's Supervisory Board of his intentions.[695] On 1 June 2005, his

[690] *Spector Photo Group NV. Chris Van Raemdonk v Commissie Voor Het Bank-Fanancie- En Assurantiewezen (CBFA)* [2009] EUECJ C – 45/08 (23 December 2009) par. 66.
[691] Ibid. par. 67.
[692] Ibid. par. 69.
[693] [2012] EUECLI C – 19/11 (28 June 2012).
[694] Ibid. par. 9.
[695] Ibid. par. 10.

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plans were made known to two other members of the Supervisory Board and, on 15 June 2005, to Mr Zetsche, who was to succeed Mr Schrempp as chairman.[696]

On 6 July 2005, the head of the secretariat was also informed.[697] On 10 July 2005, the head of communications, together with Mrs Schrempp and the head of the secretariat, began preparing a press release, a public statement, and a letter to the company's employees.[698] On 18 July 2005, Mr Schrempp and the chairman of the Supervisory Board agreed to propose Mr Schrempp's early retirement and the appointment of Mr Zetsche as his successor at the meeting of the Supervisory Board. A meeting had already been scheduled for 28 July 2005.[699] A meeting of the Presidential Committee of the Supervisory Board had also already been scheduled for 27 July 2005. Neither of the notices circulated about these meetings made any reference to Mr Schrempp's retirement.[700]

On 25 July 2005, Mr Schrempp considered the issue with a member of the Supervisory Board who was also chairman of the General Works Council and the Group Works Council.[701] On 27 July 2005, that member of the Supervisory Board, having spoken about the issue with other staff representatives and with Zetsche, informed Mr Schrempp that the staff representative would vote in favour of the replacement of the chairman of the Board of Management.[702] The two other members of the Presidential Committee were informed of what was happening before their meeting began.[703] The Presidential Committee decided later in the day to propose to the Supervisory Board the following day to approve Mr Schrempp's early retirement at the

696 Ibid. par. 11.
697 Ibid. par. 12.
698 Ibid. par. 13.
699 Ibid. par. 14.
700 Ibid. par. 15.
701 Ibid. par. 16.
702 Ibid. par. 17.
703 Ibid. par. 18.

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end of 2005 and his replacement by Mr Zetsche.[704] At 18:30 Mr Schrempp informed one of the three members of the Board of Management of the proposed change, and at 19:00 he informed the other two members.[705] At 19:30 a dinner was held for the shareholders' representatives on the Supervisory Board, during which the Presidential Committee's proposal was discussed.[706]

On 28 July 2005, at approximately 09:50, the Supervisory Board resolved that Mr Schrempp would step down at the end of the year and that Mr Zetsche would replace him.[707] At 10:02, Daimler AG sent a communication, about what had taken place, to the stock market authorities and the Federal Office for the Supervision of Financial Services.[708] The communication was published at 10:32, in the database of the German ad hoc disclosure company.[709] The price of Daimler AG shares, which stood at EUR 36.50 at market opening on 28 July 2005, rose substantially. First to EUR 40.40 and then to EUR 42.95.[710]

Numerous investors who had sold shares before the increase in the share price sparked by the announcement of Mr Schrempp's retirement at the end of 2005, initiated proceedings for damages. They based their claim on a statutory requirement that inside information be made public without delay and insisted that the announcement had been made late.[711] The case came before the Oberlandesgericht Stuttgart. It found that inside information had not come into existence until the Supervisory Board took its decision at 09:50 on 28 July 2005. The Bundesgerichtshof, however, quashed that judgment and referred the case back to the

[704] Ibid. par. 19.
[705] Ibid. par. 20.
[706] Ibid. par. 21.
[707] Ibid. par. 22.
[708] Ibid. par. 23.
[709] Ibid. par. 24.
[710] Ibid. par. 25.
[711] Ibid. par. 26.

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Oberlandsgericht Stuttgart.[712] The Oberlandsgericht once again dismissed the claim for damages, holding that in the period between 17 May 2005 and the resolution adopted by the Supervisory Board on 28 July 2005, there had been no inside information to the effect that Mr Schrempp had stated to the Chairman of the Supervisory Board that it was his intention unilaterally to abandon his duties.[713] Specifically, the Oberlandsgericht did not, in reaching its decision, regard as inside information the information relating to the various intermediate steps that had eventually led to Mr Schrempp's resignation and his replacement by Mr Zetsche. It considered that Mr Schrempp's actual retirement, in relation to his expressed intention, while capable of influencing share prices, could not be regarded as sufficiently probable in the eyes of a reasonable investor.[714] Being called on to hear an appeal challenging the later judgment of the Oberlandsgericht, the Bundesgerichthof took the view that it required an interpretation of 2003 Directive and Directive 2003/124.[715]

It referred two questions to the Court of Justice for a ruling. First, it asked whether inside information includes information relating to the specific events leading to the conclusion of a protracted process, and which therefore causally precede the occurrence of a future set of circumstances or future event, where such information is capable of significantly affecting the prices of those financial instruments or the prices of derivative financial instruments.[716] The court held that information relating to the intermediate phases of a process, which brings into being future sets of circumstances and events capable of significantly affecting the prices of financial instruments, may be regarded as inside information, not only the future sets of circumstances and events themselves which, hypothetically, will come about.[717] Relevant to

[712] Ibid. par. 28.
[713] Ibid. par. 29.
[714] Ibid. par. 30.
[715] Ibid. par. 31.
[716] Ibid. par. 34.
[717] Ibid.

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the enquiry, held the court, were the facts that, firstly, the definition of inside information required information to be precise.

Secondly, in addition to its not having been made public, it must be capable of significantly affecting the prices of the financial instruments or the prices of related derivative financial instruments.[718] Whether a fact is a 'concluding fact' or something antecedent to what could be described as a 'concluding fact' is of no moment.[719] The court wrote:

> . . . The importance of sets of circumstances which came about in the course of a process involving several temporal phases cannot be ruled out *a priori*. What is required is simply that the public be informed of any fact which – clearly even in the case of a protracted process – is precise in nature and capable, if disclosed, of significantly affecting the prices of financial instruments or the prices of related derivative financial instruments.[720]

What is relevant is not a fact's chronological location in a process giving rise to an event, but its precision, whether it is public and whether it will affect market prices.[721]

Lafonta v AMF concerned the interpretation of point (1) of Article 1 of the 2003 Directive and the definition of, among other things, 'inside information'.[722] The referral was born out of proceedings between Mr Lafonta and the Autorite des marches financiers (the AMF, the French markets authority or regulator). The Penalties Commission of the AMF had ordered Mr Lafonta to pay a financial penalty for failing to make public, among other things, information relating to a financial operation that enabled Wendel SA to acquire a significant shareholding in the Saint-Gobain group.[723]

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718 Ibid. par. 36.
719 Ibid. par. 37.
720 Ibid.
721 Ibid. par. 38.
722 *Lafonta v Autorité des marches financiers* [2015] EUECLI C-634/13 (11 March 2015) par. 1.
723 Ibid. par. 2.

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Between December 2006 and June 2007, Wendel, a company of which Mr Lafonta was chairman of the Board of Directors, concluded with four credit institutions total return swap agreements. The underlying assets were shares in Saint-Gobain. In order to hedge their positions, the credit institution acquired a total of 85 million shares in Saint-Gobain. At the same time as its entry into the total return swap agreements, Wendel obtained financing from a bank and another credit institution, for a total amount close to that of the total return swap agreements.[724]

Between September 2007 and the end of November 2007, after having decided to phase out the total return swap agreements progressively, Wendel acquired 66 million shares in Saint-Gobain, representing 17.6% of its share capital. Wendel informed the AMF in both September and March 2008 that it had exceeded certain thresholds for the number of shares it held in Saint-Gobain.[725]

Following an inquiry into the increase in Wendel's capital holding in Saint-Gobain, the AMF found that, although Wendel had officially taken the decision on 3 September 2007 to transform the economic exposure to Saint-Gobain into an actual shareholding, the evidence showed that Wendel had intended from the outset to acquire a significant shareholding in Saint-Gobain's capital and that it was primarily for that purpose that the operation in question had been carried out.[726]

The AMF accused Wendel and Lafonta of failing to make public, among other things, the principal characteristics of the financial operation aimed at Wendel acquiring a significant shareholding in Saint-Gobain's capital and of failing to make that information public at the

[724] Ibid. par. 12.
[725] Ibid. par. 13.
[726] Ibid. par. 14.

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latest on the date the total return swap agreements had been concluded.[727] The AMF's Penalties Commission held these complaints to be well founded and imposed a substantial financial penalty on Wendel and Mr Lafonta.[728] The Cour d'appel de Paris dismissed an appeal by Mr Lafonta.[729]

Lafonta argued that only information that enables a person to predict whether the price of a security is going to increase or decrease allows him to know whether he should buy or sell. It is only then that he is afforded an advantage relative to the other traders in the market. On the facts, Lafonta argued that it was impossible to predict whether the disclosure of the information about Wendel's acquisition of shareholding in Saint-Gobain would result in an increase or decrease in Wendel's share price.[730]

The AMF argued, however, that the 2003 Directive contained no reference to the direction of the possible effect on the prices of financial instruments. According to it, any information that evidences a likelihood of a change in the price of a security, constitutes precise information. The distinction between precise information and imprecise information, they said, lies in the likelihood of the information having an effect on the market.[731] The crisp point referred to the European Court of Justice was whether the 2003 Directive should be interpreted to mean that only information that indicated the particular direction of the movement of the prices of the financial instruments would constitute inside information.[732]

The court held that the 2003 Directive did not require that inside information should make it possible to determine the direction of a movement in prices.[733] The court wrote:

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[727] Ibid. par. 15.
[728] Ibid. par. 16.
[729] Ibid. par. 17.
[730] Ibid. par. 18.
[731] Ibid. par. 19.
[732] Ibid. par. 20.
[733] Ibid. par. 38.

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> The increased complexity of the financial markets makes it particularly difficult to evaluate accurately the direction of a change in the prices of those instruments, as was stated in recital 1 to Directive 2003/124, which refers to several factors likely to affect those prices in a given situation. In those circumstances — which can lead to widely differing assessments, depending on the investor — if it were accepted that information is to be regarded as precise only if it makes it possible to anticipate the direction of a change in the prices of the instruments concerned, it would follow that the holder of that information could use an uncertainty in that regard as a pretext for refraining from making certain information public and thus profit from that information to the detriment of the other actors on the market.[734]

The 2003 Directive was soon repealed. The authoritative European Union insider trading directive is now found in Regulation (EU) No 596/2014 of 16 April 2014 (2014 Regulations) on market abuse. The 2014 Regulations records that the 2003 Directive completed and updated the Union's legal framework to protect market integrity. However, given the legislative, market, and technological developments since the entry into force of the 2003 Directive, which had purportedly resulted in considerable changes to the financial landscape, it had to be replaced.[735]

Interesting developments include the European Union's resolution that information available to a tribunal that had not been available at the time of a trade, may be used to determine whether the purported inside information was price sensitive at the time of the trade. This is made subject to the caveat that a conclusion about price sensitivity may not be made against persons who drew reasonable conclusions from *ex ante* information available to them at the time of and prior to the making of their trades.[736] In addition, and apparently as a direct result of the *Getl* case and judgment, it was resolved that where inside information concerns a process that occurs in stages, each stage of the process, as well as the overall process, could constitute inside information. An intermediate step in a protracted process may in itself constitute a set of circumstances or an event. An intermediate step should be deemed to be inside information

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[734] Ibid. par. 37.
[735] Regulation (EU) No 596/2014 of 16 April 2014 par. 3.
[736] Ibid. par. 15.

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if it, by itself, meets the criteria laid down in this Regulation for inside information.[737] It is specifically provided that information that relates to an event or set of circumstances that is an intermediate step in a protracted process, may relate, for example, to the state of contract negotiations, terms provisionally agreed in contract negotiations, the possibility of the placement of financial instruments, conditions under which financial instruments will be marketed, provisional terms for the placement of financial instruments, or the consideration of the inclusion of a financial instrument in a major index, or the deletion of a financial instrument from such an index.[738]

It was further resolved that legal certainty for market participants should be enhanced through a more detailed definition of two of the elements essential to the definition of inside information: the precise nature of that information and the significance of its potential effect on the prices of securities.[739]

The 2014 Regulations further provide that it is not intended to prohibit discussions of a general nature about business and market developments between shareholders and management. These discussions and the relationships that underlie them are, according to the Regulation, essential for the efficient functioning of markets and should not be prohibited.[740] Research and estimates based on publicly available data, should not per se be regarded as inside information, and the mere fact that a transaction is carried out on the basis of research or estimates should not therefore be deemed to constitute use of inside information. However, where, for example, the publication or distribution of information is routinely expected by the market, and where such publication or distribution contributes to the price-formation process of financial instruments, or the information provides views from a recognised market commentator or institution that may inform the prices of related financial instruments, the information may

[737] Ibid. par. 16.
[738] Ibid. par. 17.
[739] Ibid. par. 18.
[740] Ibid. par. 19.

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constitute inside information. Market actors must therefore consider the extent to which the information is non-public and the possible effect on financial instruments traded in advance of its publication or distribution, to establish whether they would be trading on the basis of inside information.[741]

The 2014 Regulation provides:

> 1. For the purposes of this Regulation, inside information shall comprise the following types of information:
>
>   (a) information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments;
>
>   (b) in relation to commodity derivatives, information of a precise nature, which has not been made public, relating, directly or indirectly to one or more such derivatives or relating directly to the related spot commodity contract, and which, if it were made public, would be likely to have a significant effect on the prices of such derivatives or related spot commodity contracts, and where this is information which is reasonably expected to be disclosed or is required to be disclosed in accordance with legal or regulatory provisions at the Union or national level, market rules, contract, practice or custom, on the relevant commodity derivatives markets or spot markets;
>
>   (c) in relation to emission allowances or auctioned products based thereon, information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more such instruments, and which, if it were made public, would be likely to have a significant effect on the prices of such instruments or on the prices of related derivative financial instruments;
>
>   (d) for persons charged with the execution of orders concerning financial instruments, it also means information conveyed by a client and relating to the client's pending orders in financial instruments, which is of a precise nature, relating, directly or indirectly, to one or more issues or to one or more financial instruments, the price of related spot commodity contracts, or on the price of related derivative financial instruments.
>
> 2. For the purposes of paragraph 1, information shall be deemed to be of a precise nature if it indicates a set of circumstances which exists or which may reasonably be expected to come into existence, or an event which has occurred or which

[741] Ibid. par. 28.

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may reasonably be expected to occur, where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instruments or the related derivative financial instrument, the related spot commodity contract, or the auctioned products based on the emission allowances. In this respect in the case of a protracted process that is intended to bring about, or that results in, particular circumstances or a particular event, those future circumstances or that future event, and also the intermediate steps of that process which are connected with bringing about or resulting in those future circumstances or that future event, may be deemed to be precise information.

3. An intermediate step in a protracted process shall be deemed to be inside information if, by itself, it satisfies the criteria of inside information as referred to in this Article.

4. For the purposes of paragraph 1, information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments, derivative financial instruments, related spot commodity contracts, or auctioned products based on emission allowances shall mean information a reasonable investor would be likely to use as part of the basis of his or her investment decisions.

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3 4 Inside information according to the equal access theory

In equal access legislation aimed not at trading by insiders, but rather at trading with inside information, the definition of inside information is all important. It determines the ambit of the prohibition and it will be the single most important concept legal practitioners have to be cognisant of when they provide advice. In a legislative regime consisting of definitions and prohibited conduct, the definition describes the information that, when known by a person at the time of the trade, should disqualify her from dealing with the information. That disqualification will obtain regardless of the position in which the trader stands to the issuing company or the company to which the securities relates.

3 4 1 If it were to be made public would be likely to have a material effect on the price or value of a security

Kunkel writes about the requirements of inside information under the equal access to information theory.[742] According to him, the duty to abstain from trading under the equal access theory should be triggered by information that has four characteristics: the information must be material; it must be non-public; it must not be derived from analysis; and the person who has knowledge of the information must either know or have reason to know that the information is non-public.[743] His requirement of 'materiality' requires the information, if it were to be made public, to affect the security's price. In other words, were the dissemination of the information not to affect the security's price, the prohibition on trading would not be triggered.[744] He does not require the information to have an effect on the 'value' of a security.

742 Kunkel (1989) *J Contemp L* 66–69.
743 Ibid.
744 Ibid.

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The South African definition's provision that inside information is information that will, upon becoming public, affect a security's 'value', is a stopgap provision. If information upon becoming public affects a security's value, it will also affect its price through the change in value's effect on the demand for the security. It may thus seem as if the provision relating to information that increases a security's value (as it is included as an alternative to the provision that relates to an increase in the security's price) is superfluous. However, practicalities dictate that information that affects a security's value will, on becoming publicly accessible, not immediately influence the security's price. It will take time for the information to be accessed, absorbed and traded on. The inclusion of the 'or value' provision is thus aimed at not allowing insider traders the advantage of trading on information which, upon becoming public, will immediately affect the security's value but will affect the security's price only after the passage of some time. It should remain a part of the definition.

The King Task Group was of the view that the impact of the information on the price or value of a security should be 'material' rather than 'significant' (which was the word used in the then corresponding legislation in the United Kingdom).[745] In the United States, the information itself is required to be material.[746] That test incorporates an enquiry about whether the information would have an effect on the price of the security if it were disclosed. Importantly, however, the test for materiality and whether information would have an effect on the market price of the security, encompasses any fact that, in the reasonable and objective contemplation of a hypothetical reasonable investor, might affect the value of the corporation's securities. This would include an analysis of whether the information, having the level of specificity that it does, would in reasonable and objective contemplation of that hypothetical investor, affect the value of a corporation's securities or the securities related to a corporation. The Australian provisions also require a hypothetical test and ask whether a reasonable person would expect the information to have a material effect on the price or value of the financial product.[747] The

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[745] King Final Report 10.
[746] See par. 3.3.1 above.
[747] See par. 3.3.2 above.

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European Union also requires that, if it were made public, the information would be likely to have a significant effect on prices.[748]

The South African requirement that information must be 'likely' to have an effect on the prices of securities and the hypothetical reasonable investor test employed in other jurisdictions, are related. They are alternatives to requiring information that, simply, 'affect' security prices. In addition, 'likely' incorporates a foreseeability requirement into the definition. In South African the 'reasonable person' test used to determine whether a person was negligent for the purposes of delictual and criminal liability, includes a foreseeability element.[749] Generally, a person is negligent if a reasonable person would have foreseen the possibility that her conduct might bring about a particular result, would have taken steps to guard against such occurrence, and failed to take such steps.[750] The 'likely' requirement relates to whether the trader foresaw that, if the information was to be made public, it would be likely to affect the price of the security. There is no reason, however, why this foreseeability test must be included in the definition of inside information. If the legislature is of the intention to include such a test into the legislative scheme, it would best be done either as an element of prohibited conduct or as a defence afforded to a trader who is prima facie guilty of insider trading. There is also no reason why this foreseeability requirement must be limited to the price-sensitivity factor in the definition of inside information. The test, if it were to be included, must provide the insider with the defence that she, at the time of the trade, could not have reasonably concluded that the information in her possession was inside information.

The King Task Group's decision in respect of material was made on the basis that there is extensive case law in South Africa on the meaning of 'material', particularly in relation to fraudulent misrepresentation.[751] This reason for the inclusion of the materiality standard does

[748] See par. 3.3.3 above.
[749] *R v Meiring* 1927 AD 41 46.
[750] *Kruger v Coetzee* 1966 (2) SA 428 (A) 430 and *S v Van As* 1976 (2) SA 921 (A) 927–929.
[751] King Final Report 10.

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not make much sense. Materiality in respect of fraudulent misrepresentation is found in a different context, was developed in a different context, and performs a different function in that context. In the test for fraudulent misrepresentation, materiality is one of five requirements: a precontractual incorrect statement; which was material or wrongful (and unlawful); made by the other party to the contract; with the intention of inducing the contract; and which induced the contract or caused the representee to suffer a loss.[752]

Importantly, what is meant by 'material' in relation to the misrepresentation, is that the misrepresentation must have induced the contract.[753] In the context of insider trading, there is no misrepresentation by a counterparty. The trade takes place on a stock exchange, where traders do not communicate. At the time of the trade, the information known to the insider, which would have been the subject of the misrepresentation in the normal contractual context, is neither known by the innocent party nor communicated to him. What is an immaterial fact for the purposes of fraudulent misrepresentation, might have a material effect on the price or value of a security. Materiality in relation to the definition of inside information, relates to the 'effect on the price or value of any security listed on a regulated market or of any derivative instrument related to such a security'. The wrong underlying insider trading on stock exchanges, whichever theory of wrongfulness one would support, is not found in a misrepresentation made with the intent to induce a transaction. Questions about misrepresentations are irrelevant for the purposes of insider trading. So is the test relating to the effect of such a misrepresentation.

The materiality requirement as it is found in the South African definition, can relate to only the size of the change in the price of the relevant security. In other words, where that effect

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752 A D J van Rensburg, J G Lotz, T A R van Rhijn, R H Christie & R D Sharrock "Contract" in W A Joubert & J A Faris *LAWSA 9* 3ed (2015) par. 318.

753 J C De Wet & A H van Wyk *De Wet en Van Wyk – Die Suid-Afrikaanse Kontraktereg en Handelsreg* 5ed (1992) 46. *Karroo & Eastern Board of Executors v Farr* 1921 AD 413 420; *Frost v Leslie* 1923 AD 276 279; *Pathescope (Union) of SA Ltd v Mallanick* 1927 AD 292 307 and *Novick & another v Comair Holdings Ltd & Others* 1979 (2) SA 116 (W) 149.

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would be material, as opposed to negligible, the requirement is fulfilled. In this also lies the most elementary problem with the materiality requirement in the South African insider trading context. When would a movement in securities' prices not be material? It is difficult to imagine. For if a trader acquires enough securities of a low value (say 1 cent shares) and of a particular kind, a 1 cent increase in the value of the security will double the investment. In other words, what is a material movement in the price of a security, depends on the extent of the position the specific trader takes in that security. A broader requirement that relates simply to 'a movement in the price of the security', rather than a 'material movement' would be better suited to the definition. There is no reason why insiders should be afforded the advantage of a defence that he or she foresaw only a movement in prices, as opposed to a material movement.

In any event, the *de minimis* principle and the leading of expert evidence to show that the information would have been able to move prices, render redundant the necessity for a materiality requirement. In addition, evidence about actual price movements in securities would assist in determining the nature of the information in a trader's possession at the time of the trade. This type of evidence is allowed in the United States. It is also allowed in Australia. The European Union allows for *ex ante* information to determine whether the information was price sensitive at the time of the trade. This is made subject to the caveat that a finding about price sensitivity may not be made against persons who drew reasonable conclusions from *ex ante* information available to them at the time of and prior to making their trades. There is no reason why South African litigants should not be able to lead *ex post facto* evidence on whether, at the time of the trade, the information in question would have moved the relevant security's price had the information become lawfully accessible to the public, for the purposes of showing that the information was not inside information at the time of the trade. There is also no reason why parties would not be allowed to lead expert evidence in terms of Uniform Rule of Court 35(9) to that effect.

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3 4 2 Learned or obtained as an insider

The source of the information and the way in which it was obtained might play a role in the enquiry as to whether information was lawfully available to the public, but they are not requirements in themselves. The requirement in the Financial Markets Act that for information to be recognised as inside information, it must be learned or obtained as an insider, is neither to be found in the Australian, European Union or United States definitions, nor in Kunkel's theory. The inclusion of this requirement in the South African definition of inside information has attracted well-deserved criticism.[754] It is here, within the definition of inside information, that the extra link between a corporation and the insider trader is made part of our law. The requirement endorses the notion that some sort of duty (or other link), which connects the possessor of the inside information to the corporation to which the inside information relates, is required to establish an insider trading offence. The requirement further only serves to found the circularity Jooste complained of more than a decade ago. It has no place in a South African regulatory regime based on the equal access to information theory.

The requirement that the information must have been 'learned or obtained' is equally problematic. In the broader regulatory regime, knowledge of the information at the time of the impugned trade is important, not necessarily the means by which that knowledge was obtained. In any event, the word 'obtained' is, as it was explained in *M'Tali*[755] and *Scher*[756] and as it is clear from the word's dictionary definition, a word of the widest connotation. Obtained does not necessarily require any positive action on the part of the person that received the information. Even if information is given to a person without that person necessarily asking for it or making any effort to acquire it, he would have obtained it. The term therefore

[754] See Jooste 2006 *S African L J* 438.
[755] See p. 146 above.
[756] See p. 146 above.

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covers all means by which a person could come into possession of inside information and adds nothing to the possession requirement.

Leaving aside the fact that the inclusion of 'learned' is ill-considered as 'obtained' includes 'learned' within its ambit, 'learned' specifically leaves the definition open to an interpretation that information obtained by experience or study is included within the definition. Traders should not be prohibited from trading with an advantage attributable to their own, legally employed, 'greater insight or expertise in evaluating … a company's prospects'.[757] I therefore partly agree with Kunkel's[758] and Steinberg's arguments that inside information must not be derived from analysis.[759] The consideration, that market analysts and their clients must be allowed to trade with information obtained through experience and skill, should not be taken too far. To exclude from the definition information obtained by analysis without more would do so. It implies a blanket endorsement of trades made with the help of analysis. That would condone the conduct of traders who analyse data not available to the public, to trade freely with information others cannot have had access to. This is irreconcilable with the protection and promotion of the economic role of market makers and researchers, who gather their information by experience and study. While the legislature should incentivise trade on information obtained by study, experience and research, it should guard against giving market professionals free reign in trading on information they obtained through employing some skill or expertise. The express inclusion of 'learned' should be taken out of the definition, but there is no express exclusion required in the definition either.

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[757] *Langevoort on insider trading* (Rel 7 4/2009) 5-1.

[758] Ibid.

[759] Steinberg *International Securities Law: A Contemporary and Comparative Analysis* 110 footnote 39.

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3 4 3 Data, information and non-information

A further issue is whether the equal access theory requires the definition to be limited to information or whether raw data should be included within the definition. All the jurisdictions considered use the term 'information'. It is one-half of a term of art (inside information) used widely in financial market regulation. Data is something which is generally understood to be converted into information by way of the employment of some skill.

It is not necessary to include in the regulatory framework a provision specifically aimed at addressing data not accessible to the public. If the definition of inside information includes a requirement that inside information is information not lawfully accessible to the public, it would include in its scope information that is learned through the evaluation of data that cannot be lawfully accessed by all.

The same reasoning is applicable to information obtained by supposition or deduction. If the information, or data for that matter, which was required to make the supposition or deduction, was lawfully accessible to all, the information in question is not inside information. In other words, if it was lawfully possible to any member of the public to make the supposition or the deduction, the information would not be recognised as inside information.

Salbu also deals with a concept he calls 'noninformation'.[760] He describes it as

> something less than factual information, such as factual suspicions, shrouded or veiled information, and sensations communicated without language but rather by attitude, implication, enthusiasm, or a figurative wink.[761]

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[760] S R Salbu "Tipper Credibility, Noninformational Tippee Trading, and Abstention from Trading: An Analysis of Gaps in Insider Trading Laws" (1993) 68 *Wash L Rev* 307.

[761] Salbu (1993) *Wash L Rev* 320.

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Noninformation would be involved where an insider assures someone that inside information exists, but does not actually communicate factual information.[762] He says that noninformation, although not to the same degree as inside information, also tends to lower the risk of the relevant share trade.[763]

Salbu's distinction serves to overcomplicate the enquiry. What he calls noninformation, such as the figurative wink, can be classed as information in and of itself. The concept is simply information that is not as directly related to the security as other types of inside information. This type of indirect information remains information. If, on its becoming accessible to the public, it would have an effect on the price of securities listed on a regulated market, and it was not so accessible at the time of the trade, it is included in what I propose the definition of inside information should be.

The inclusion of the term 'information', as opposed to 'information and data', suffices.

3 4 4 The non-public requirement

The United States has a non-public requirement.[764] The test is sometimes aimed at the number of people who possess the information, sometimes at whether the trading of those who possess inside information has caused the information to be fully reflected in the price of the particular security, and sometimes at whether the information is not generally available to the ordinary investing public. The United States courts, as it is evidenced in the judgment of *Speed*, are not always clear whether part of their enquiry into inside information includes an enquiry into the

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762 Salbu (1993) *Wash L Rev* 328.
763 Ibid. 330–331.
764 See par. 3.3.1 above.

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information's source. In Australia, the requirement is that the information is not to be generally available.[765] The European Union requires the information to have not been made public.[766]

So does Kunkel. He includes within this requirement three sub-elements: the information has to emanate from a non-public source; it has to be confidential; and it must not be available to the general public through another source.[767] According to Kunkel, information that originates from a public source, such as the public release of a geographical survey that identifies iron ore deposits, should not activate the prohibition.[768] For the information to be inside information, it must also not be generally available from another source.[769] The second non-public element, that the information has to be confidential, includes a sub-element that focuses on whether the source of the information intended for the information is to be kept confidential.[770] According to Kunkel, only where the original source intended for the information to be kept confidential, should the prohibition obtain.[771]

I disagree with Kunkel. Peremptory requirements as to the information's source and the intention of the source, are incompatible with the equal access theory. They are merely some of the factors that go to whether the information in question was accessible to all at the time of the trade. In other words, the facts that go to the information's source or the source's intentions in respect of the information could be relevant only in as far as they may assist a factfinder in the circumstances of a particular case to conclude that the information was not accessible to all at the time of the trade. The test as to whether information is inside information is to be done in relation to the facts as they existed at the time of the trade. Information that originated at a non-public source, which the source intends to keep

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[765] See par. 3.3.2 above.
[766] See par. 3.3.3 above.
[767] Kunkel (1989) *J Contemp L.* 68.
[768] Ibid. 69.
[769] Ibid.
[770] Ibid. 68.
[771] Ibid. 69.

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confidential, could become public subsequent to its production, but prior to the trade. The information's source and the source's intentions at the time of its production, can therefore not be self-standing requirements.

Steinberg identifies two views about when inside information becomes public.[772] The first view is that when information is disseminated and absorbed by the investment community, it is public. According to the second view, information is only deemed to be public when the 'active' investment community becomes aware of the information.[773] Equality of access cannot, however, be limited to the investment community, nor the active investment community. It will defeat the very purpose of drawing further funds, previously unavailable, to the financial markets. In addition, any concerns about overregulation are addressed by the fact that 'lawful' access is protected. It will always be open to the established trader or a member of the 'active' investment community to argue that her counterparty could have had lawful access to the information (and traded successfully with its benefit) if the counterparty had the education, experience and skill of herself.

The inclusion in the definition of the requirement that the information must not be lawfully accessible to the public, replaces the 'non-public' requirement. The Financial Markets Act's section 79 (and its non-exhaustive list of situations where information would be regarded as having been made public) should be removed for that reason, but also for two others. First, if such a section is to be included at all, it would be a section about information not capable of being accessed by the public. Second, the section forms part of the definition of inside information. Yet, it provides a non-exhaustive list. It is therefore not definitive. That destroys the very purpose behind the section: to define inside information. If the legislative regime is based on principle, capable of application to all factual scenarios, what sense does it make to have a section setting out some of those scenarios? None, barring perhaps to assist the insecure

[772] Steinberg *International Securities Law: A Contemporary and Comparative Analysis* 110 footnote 39.
[773] Ibid.

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lawyer who looks to match his client's case to an example, rather than arguing which outcome a principle supports.

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3 4 5 Specific, precise, and related requirements

The United States courts deal with preciseness and specificity within the context of their broad flexible test for materiality. The European Union also requires information to be precise. It includes a requirement of specificity within its definition of precise. Its courts stumble over this requirement. Take, for example, the *Lafonta* judgment, which caused an amendment of the European Union definition of inside information. The court grappled with the question whether information relating to circumstances or an event in an intermediate phase could still be specific and precise to constitute inside information. One has to ask why this is relevant. Whether the information is specific or precise, or whether it is in an intermediate phase or not, is of no import; it is whether that information is capable of moving market prices that remains the relevant issue.

Kunkel does not require inside information to be specific or precise. In Australia specificity and preciseness are not requirements. In that jurisdiction, as it has been said, the definition of information includes matters that are 'insufficiently definite to warrant being made known to the public'; and at least one court recognised that information that may influence securities markets, may be quite imprecise. I agree with that approach.

Once it has been ascertained that the information, once made public, would have an effect on the price or value of a security, why is it necessary that it must be specific or precise? Who is to say that, in certain circumstances, vague and imprecise information will not have a material effect on the price of a listed security once published? Surely traders should also fall foul of the prohibition if they have information that is not accessible to the public, that will have an effect on the price of the security once it becomes so accessible, but that is vague and imprecise. As is evidenced by the United States *Mayhew* case,[774] information not available to

[774] See p. 159 above.

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the public is analysed in the context of related information that is already public.[775] The question in each instance would be whether the additional information, having been made public, would have an effect on the price of the security. There is nothing to say that the additional information, which gives the insider his edge, is specific and precise. It quite simply does not have to be in instances where much information is already accessible to the public.

The purpose of the specificity and preciseness requirements are intended to guard against overregulation. This motive cannot be faulted. The legislature must, however, also be careful of producing arbitrary provisions that, while they may guard against overregulation, have no foundation in principle and could serve only to unnecessarily encumber the application of the regulatory scheme. If the *Zietsman* judgment is indicative of anything, it is that having these requirements in the definition takes the court's attention away from what should be the true factual enquiry. Whereas the court in *Zietsman* held that, in enquiring whether or not a fact is inside information, significance must be attributed to its ability to affect market prices,[776] that inquiry gets lost in the court's grappling with the specificity and preciseness requirements.

The specificity and preciseness of information are merely among the indicators that information may affect market prices on becoming legally accessible to all, but they are not

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[775] See in this regard R C Sauer "The Erosion of the Materiality Standards in the Enforcement of the Securities Laws" (2007) 62 *Bus Law* 317 321–322 where the author writes:

> Determining which facts if added, singly or in combination, to the "total mix" of available information would have been important to investors in a specific stock on a particular day is a highly circumstantial enquiry. First, investors apply different criteria to different market sectors. Changes in dividend rates, for example, may be of paramount importance to investors in utility stocks but less significant to investors in growth stocks. Investors also weigh differently various performance factors among companies in the same sector. Top line revenue may matter more than earnings for a recent entrant trying to build market share as opposed to a more mature company. Cash flow from operations may take on greater significance for a thinly capitalised venture. Such distinctions are endless and may change rapidly and without warning. Indeed, professional stock analysts often find themselves at a loss to explain the market's response to particular corporate developments.

[776] *Zietsman* 28.

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the only indicators to that effect.[777] Proof that the information was specific or precise might even be a good indicator of the fact that the information in question is price sensitive, but there is no reason to be found in the principles of the equal access theory that price sensitivity could not be proved in some other manner.

A court needs room to assess information outside the strictures placed on it by the requirements that information must necessarily be specific or precise. The requirements should be removed from the South African definition of inside information. A requirement that the information must be capable of affecting the price of a security, suffices.

The same reasoning applies to many other types of information that have occupied the minds of courts and legislators. Once it is accepted that the information in question is not lawfully accessible to the public, the only remaining enquiry must be: will the information affect market prices on becoming so accessible? Whether the information be false or true, it is not a primary consideration. Whether the false or true information in question affects or would affect the market price of the security, is. Whether the information is part of a larger mosaic of information, is not of primary importance; whether the information in question forms 1 per cent of a larger whole, of which 99 per cent was already accessible to the public, is not of primary importance. Whether the market price will be affected on the 1 per cent being made public, is. Whether the information relates to uncertain future events, is not of primary importance. Whether the information in question will move market prices on becoming accessible to the public is. Whether the information relates to someone's intention, can be classed as rumour, eventually proves to be false, or could be qualified as opinion, or predictions or forecasts, the test remains the same.

[777] For similar reasoning in the wholly different context of rectification, see the judgment of De Wet CJ in *Meyer v Merchants' Trust Ltd* 1942 AD 244 253.

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Should the information inform the prospective trader of the direction in which the share price is to move? I submit not. It should be sufficient to know that the price will move. Whether the information allows the trader to correctly or incorrectly predict a movement in the price of a security is irrelevant to the wrongfulness of the trade.

3 5 Conclusion

The equal access to information theory requires inside information to have two characteristics. First, the information must not be lawfully accessible to the public. Second, on the information becoming lawfully accessible to the public, it must have an effect on the price or value of a security listed on a regulated market. The first characteristic replaces the misappropriation theory or the fiduciary duty doctrine's requirement of a link between the entity in whose securities a trade is being made and the trader. That link is not a self-standing peremptory requirement; its existence might be one of many facts that go to show that the information was not lawfully accessible to all. The second characteristic is to replace all the other intrinsic characteristics currently required for inside information by the Act. The other intrinsic characteristics contained in the definition are intended to describe information that, upon becoming public, moves security prices. The price sensitivity requirement renders those other requirements redundant.

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4 INSIDERS

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4 1 Introduction

The Act defines the term 'insider' as:

> a person who has inside information—
> (a) through—
> (i) being a director, employee or shareholder of an issuer of securities listed on a regulated market or an issuer of derivative instruments related to such securities to which the inside information relates; or
> (ii) having access to such information by virtue of employment, office or profession; or
> (b) where such person knows that the direct source of the information was a person contemplated in paragraph (a).[778]

If a person who has inside information falls within one of the categories of insider created by the definition, she will be recognised as an insider. If a person who has inside information does not fall within one of those categories she, even though she has inside information, will not be recognised as an insider for the purposes of the Act. This gives rise to questions. Should everyone not be allowed to participate in the financial markets with inside information? If not, should everyone be prohibited from doing so? If not, who should be prohibited from doing so? What underlies the Act's categories of insider that identify who is prohibited from participating in the financial markets with inside information? And, lastly, what role does the definition of insider have to play in a regulatory regime based on the equal access to information theory?

[778] Section 77 of the Act.

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4 2 Should everyone be allowed to trade with inside information?

Ever since the advent of insider trading regulation, it has been argued that certain economic actors should be allowed to trade with inside information. Some, such as Manne, have argued primarily that insider trading should not be regulated at all. In other words: everyone should be allowed to trade with inside information. He wrote in the context of the early stages of the great insider trading debate, with both academic and judicial discourse focusing on managers and directors. Manne's arguments provide the context for the enquiry into who must be an insider.

Manne challenged established academic views with his 1968 book, *Insider Trading and the Stock Market*.[779] His broad thesis is that earlier works on insider trading failed to appreciate the wider analysis undertaken by economists and that, if that were done, analysts would inevitably realise that trading on inside information contributes to market efficiency.[780] He accepts that when one focuses on the sale between the buyer and the seller of shares, trading on inside information could be seen as unfair. He argues, however, that a broader perspective is needed for insider trading's positive effects to become apparent. Trading on inside information, specifically by managers and directors of firms, has an impact on all traders (not only the insider's counterparty), and on the efficiency of the allocation of resources and the productivity of the economy generally. Manne's book, subjected to a great deal of counterargument, led the debate about insider trading out of the realm of morality and into that of economics.[781]

779 H G Manne *Insider Trading and the Stock Market* (1966).
780 R A Schotland "Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market" (1967) 53 *Va L Rev* 1425 1440.
781 Ibid. 1430.

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He advances three main arguments.[782] Firstly, he argues that insider trading contributes to the efficiency of stock market pricing. Secondly, he argues that the practice of insider trading does not do significant harm to long-term investors. Thirdly, he makes the compensation argument, which holds that insider trading and the returns it offers to managers and directors are to be viewed as a component of executive compensation. The first two arguments are relevant to all economic actors with inside information. The last is relevant to whether directors and managers are to be held liable for insider trading.

As to the first two arguments, according to Manne trading on inside information always has the effect of moving the price of a security in the 'correct' direction.[783] The argument proceeds from the generally accepted economic truth that trading on positive information in a company's securities, increases the demand for a particular security, putting upward pressure on its price, moving the price of the security closer to its underlying value. A trade on inside information effects an incorporation of the information into the price of the security. Manne argues that, although the volume of insider trading is small relative to the total trading in the financial markets, it affects securities' prices by inducing others to mimic the initial slight market movement and to join in the trading of the primary insiders.[784] The initial trades happening on the basis of inside information, although small in volume, would have a bandwagon effect. In addition, argues Manne, insider trading not only renders the pricing of securities more accurate, it causes gradual instead of sudden and erratic security price movements. Each trade on inside information moves the price of the security incrementally closer to its 'efficient' level.

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[782] H G Manne "Hayek, Virtual Markets, and the Dog that Did Not Bark" (2005) 31 *J Corp L* 168.

[783] Manne (2005) *J Corp L* 169. For empirical evidence that supports Manne's assertion see J Lin & M S Rozeff "The Speed of the Adjustment of Prices to Private Information" (1995) 18 *J Fin Res* 143 and L K Meulbroek "An Empirical Analysis of Insider Trading" (1992) 47 *J Fin Res* 1661.

[784] Schotland (1967) *Va L Rev* 1443.

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This is Manne's least controversial argument. At least the assertion that insider trading moves market prices, is not only supported empirically, it is generally accepted as correct.[785] The extent of the effect and the time lag between the incidence of the trade and the effect are, however, questioned.[786] Manne also fails to take account of two considerations.[787] Firstly, the extent to which persons with inside information could affect market prices is limited because they have limited resources, including a limited ability to obtain credit. Secondly, the increase in the price of a security brought about by traders using inside information could have more than one effect.[788] The initial trades could well induce traders on the buying side, as Manne suggests, to buy the securities, as the initial effect could be interpreted as indicating further possible price increases. Insider trading could, however, also affect the selling side. Just as an unexplained price rise may convince some to buy, it will convince others that the share is overpriced, and they may be persuaded to sell their shares, or to sell short.[789]

Insider trading could also prove detrimental to the efficiency of the pricing mechanism through causing the prices quoted by market makers not to reflect the securities' underlying value. This proposition is supported by Treynor's adverse selection argument.[790] The adverse selection argument is based on two main concepts: market makers and the bid-ask spread. A market maker facilitates a market for securities. He holds a certain number of securities in stock in

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785 Lin & Rozeff (1995) *J Fin Res* 143 and Meulbroek (1992) *J Fin* 1661.

786 S Chakravarty & J J McConnel "Does Insider Trading Really move Stock Prices?" (1999) 34 *J Fin & Quantitive Analysis* 191.

787 Schotland (1967) *Va L Rev* 1446.

788 Ibid. 1445.

789 Ibid. 1445. The short seller sells securities that he does not own, but has, for instance, borrowed, at the price that obtains at the time of the sale. His inventory is then short the number of securities sold. The short position is closed by the trader buying the securities at a lower price at a later stage, returning them to their owner, and retaining the profit.

790 Dolgopolov (2004) *Cap U L* Rev 92.

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order to enable immediate trading in that security.[791] The market marker buys securities when they are offered and sells securities when they are demanded.

The bid-ask spread explains how market makers earn their profits. The 'bid' is the offer made by the market maker for the security. The 'ask' is the price the market maker is willing to accept for the particular security. The difference between the bid price and the ask price is the 'bid-ask spread'. For example, if the market maker offers to buy a specific security at R100 and he offers to sell that specific security at R105, the bid-ask spread is R5. This difference is the market maker's profit. The bid-ask spread is due compensation to market makers as they fulfil a valuable function in the securities markets.[792] They absorb the risk of keeping securities in their inventories to provide a continuous supply and demand of securities, keeping the market liquid.[793]

The adverse selection argument is based on the proposition that market makers will deal with both traders with inside information and traders without inside information. It accepts that market makers do not generally have inside information. It further accepts that market makers are aware of the fact that they will deal with insiders and that they, the market makers, will

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[791] H Demsetz "The Cost of Transacting" (1968) 82 *Quarterly Journal of Economics* 33 35 writes:

> On the NYSE two elements comprise almost all of the transactions cost – brokerage fees and ask-bid spreads. Transfer taxes could be included, but it is expedient to concentrate our attention on the two major components.
>
> The inclusion of the ask-bid spread in transaction costs can be understood best by considering the neglected problem of "immediacy" in supply and demand analysis. Predictable immediacy is a rarity in human actions, and to approximate it requires that costs be borne by persons who specialize in standing ready and waiting to trade with the incoming orders of those who demand immediate servicing of their orders. The ask-bid spread is the markup that is paid for predictable immediacy of exchange in organized markets; in other markets, it is the inventory markup of retailer or wholesaler.

[792] Dolgopolov (2004) *Cap U L* Rev 88 note 27. G J Stigler "Public Regulation of Securities Markets" (1964) 37 *J Bus* 117 129 note 16 held that the bid-ask spread is a cost society endures for the benefits of '(1) immediate availability of a buyer and seller; (2) the elimination of short run fluctuations in price'.

[793] Dolgopolov (2004) *Cap U L Rev* 89.

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make corresponding adjustments to the spread. As the market maker is aware that she will, on occasion, trade with insiders and that she will suffer a loss as a result of those trades, she will lower the prices she offers for securities and increase the prices she asks for them. In other words, she widens the bid-ask spread of all the securities she trades in. That insider trading leads to a widening of the bid-ask spread, has been widely accepted as correct.[794] Market makers shift the harm they perceive will be caused to them by the use of inside information, to all the traders they deal with.[795] The amount by which the bid-ask spread is widened is referred to as the 'insider trading tax'. All other things held constant, the insider trading tax will cause some traders to leave the market, while some will not trade on the prices on offer, affecting market liquidity.[796] More pertinently, when market makers perceive insider trading as prevalent in a market, the consequent adjustment, the effort to protect themselves, causes market prices to move away from their efficient level.

Insider trading also detrimentally affects companies' cost of capital.[797] According to Gower and Davies, where insider trading happens in a market, outsiders (people who have neither inside information or an inside position) will know that the market prices fail to reflect companies' true value and that dealing on the quoted prices will cause them harm.[798] Outsiders will build this risk into their investment analysis and will accordingly lower the price that they will be prepared to pay for a company's securities. This will increase all companies' cost of capital as they have to offer securities to the market on less favourable terms.[799]

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794 Ibid. 83.
795 Bagehot (1971) *Fin Analysts J* 12.
796 Z Goshen & G Parchomovsky "On Insider Trading, Markets, and 'Negative' Property Rights in Information" (2001) 87 *Va L Rev* 1229 1251.
797 Gower & Davies *Gower and Davies' Principles of Modern Company Law* 751.
798 Ibid.
799 Ibid.

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The insider trading tax and insider trading's effect on companies' cost of capital provide an answer to Manne's insistence that, if one were to assert that insider trading is unfair or that it harms someone, one has to be able to identify that someone.[800] Manne argued:

> Ultimately the complaint must be that some individuals are being harmed by insider trading. It is not enough to simply say that insider trading is unfair. If it is unfair, it must be unfair to someone.[801]

The widening of the bid-ask spread has a negative effect on market liquidity generally and leads to an increase in the cost of capital to companies. Seeing these effects of insider trading in the light of the financial markets' role in society, leads to the conclusion that trading on inside information affects economic growth and hurts society as a whole. Leaving aside the unfairness inherent in a specific trade, there is unfairness in traders making insider trading profits at the cost of society.

Manne's reply to the adverse selection argument and the consequent insider trading tax is as simple as it is unconvincing. According to Manne, the adverse selection argument exists more in theory than in practice. Liquidity providers in the stock markets, says the author, 'are not generally concerned about the presence of insiders in securities in which they make a market'.[802] For this argument to hold any sway, it must be accepted that liquidity providers 'are not generally concerned' about whether they, who depend on research to ply their trade, have access to all the information some of their fellow market participants have access to. That cannot be accepted. If a rational market maker has considered all the information available to her and has determined the prices she is willing to offer and accept, and then becomes aware that there is still information that she cannot have access to and that there will be other market participants trading on that information, she will of course adjust her prices. There is no reason why she would be willing to make less of a profit or suffer a loss on some of her deals, without

[800] See Bagehot (1971) *Fin Analysts J* 12; T E Copeland & D Galai "Information Effects on the Bid Ask Spread" (1983) 38 *J Fin* 1457; L R Glosten & P R Milgrom "Bid, Ask and Transactions Prices in a Specialist Market with Heterogeneously Informed Traders" (1985) 14 *J Fin Econ* 17.

[801] H G Manne *Insider Trading and the Stock Market* (1966) 93.

[802] See H G Manne "Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark" (2005–2006) 31 *J Corp L* 169 note 9.

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compensating for those shortfalls or losses with a general price adjustment. That adjustment will move securities' prices away from their underlying value, rendering the pricing mechanism less efficient.

Manne also argues that the practice of insider trading causes no significant harm to the long-term investors in the stock market.[803] In essence, the argument is that insider trading would not cause fluctuations in share prices of such a magnitude that it would lead to significant harm in the long run. He accepts that short-term traders would be harmed when dealing with insiders. He asserts, however, that as short-term trading is comparable to gambling, a legislature's focus should rather be on the effect insider trading has on long-term investors.[804]

This argument also does not hold.[805] It is based on the incorrect assumption that time is the only factor for consideration in the investment decisions made by investors in long-term investments.[806] It is implied that an investor evaluates the overall market to assess only when the specific investment is to be made, ignoring the fact that the price of a particular security, at the time of the purchase, will also be taken into account by the investor.[807] In addition, in practice, many investors own more than one security in one firm. When they need funds, investors assess all the securities they hold. In that assessment they compare the different securities' prices to their values. Price is therefore an important factor for long-term investors to manage their portfolios in the short-term.[808] Managing a portfolio is in any event an ongoing process by investors who may, in some shares, be long-term investors, and in respect of others, short-term investors. Price remains a major factor to consider by all investors in all their security transactions.[809] Trading by insiders with information to which other investors cannot

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[803] Ibid. 167–174.
[804] Ibid.
[805] Schotland (1967) *Va L Rev* 1447–1452.
[806] Ibid. 1430.
[807] Ibid.
[808] Ibid. 1447.
[809] Ibid.

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not have access, hurts investors, whether they are to be described as long- or short-term investors.

Unfettered insider trading will also create the impression that the securities' markets are unfair and would detract from the securities' markets integrity generally.[810] This affects not only short-term investors; it affects investors across the board. In circumstances in which an investor knows, or at least is assured, that insider trading is under control, he would know that the losses that he does suffer, are not suffered because of some unerodable advantage held by his counterparties in the securities markets. Schotland writes:

> [b]y no means do I suggest that a long-term investor will consider the presence of insider trading to be as important to his investment decisions as are the security's fundamental soundness, dividends and growth potential. But the investor can choose from among many stocks and several markets, and all things being equal, his decision may well be influenced by his view of the "fairness" he is likely to find. Surely, of all the people we want to encourage to participate in the stock market, the long-term investor comes first, and we should allow no practices that discourage his participation, unless such practices bring demonstrable overriding benefits.[811]

Insider trading is not a suitable means by which the efficiency of the price mechanism is to be promoted. To require the timeous disclosure of information would be better suited to that objective as it does not come at the price of market integrity.[812] Nor does insider trading affect only short-term investors. It affects all investors. Our legislature cannot be faulted for having chosen to prohibit trading on inside information. Has it, however, correctly identified who is to be prohibited from doing so?

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[810] Ibid.

[811] Ibid. 1440.

[812] R J Gilson & R H Kraakman "The Mechanisms of Market Efficiency (1984) 70 *Va L Rev* 549 and R J Gilson & R H Kraakman "The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias" (2003) 20 *J Corp L* 715.

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4 3 The closed group approach

The legislature creates two main types of insider in the Financial Markets Act. As a point of departure, it creates a closed group of insiders, or primary insiders, in section 77(a). Second, as a result of the apparent inability of section 77(a) to incorporate all persons who should be prohibited from participating in the markets with inside information, section 77(b) creates tippees. In what follows, the different insiders recognised by the definition are set out and the arguments whether each type of insider should be prohibited from participating in the financial markets with inside information are considered. Ultimately it is asked whether this closed group approach is the most appropriate to achieve the legislature's objectives with financial market regulation.

4 3 1 Primary insiders

Primary insiders, identified in subheading (a) of the definition, are divided into two subcategories.[813] The first category's insiders, found in subsection (a)(i), are directly connected to the issuer. A person who has inside information is an insider if she, in terms of subsection (a)(i), has inside information through being a director, or an employee, or a shareholder of an issuer of securities listed on a regulated market, or an issuer of derivative instruments related to such securities to which the inside information relates. The subsection includes traditional fiduciaries and quasi-fiduciaries. The second category's insiders, found in subsection (a)(ii), are not directly connected to the issuer. The subsection includes missapropriators. Subsection (a)(ii) does not mention 'issuers'. The employees, officers and

[813] Section 77 of the Act.

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professionals it includes are recognised as insiders through having access to inside information 'by virtue' of their 'employment office or profession'.[814]

4 3 1 1 Directors and managers

The Financial Markets Act recognises as insiders persons who have inside information through being directors of issuers of securities listed on a regulated market or issuers of derivative instruments related to such securities to which the inside information relates.[815] Directors are also generally recognised as 'insiders' in as far as they have access to inside information by virtue of their 'employment' as directors or by fulfilling the 'office' of a director.[816]

The Financial Markets Act does, however, not contain a definition of the term 'director'.[817] The term is to be given the meaning it has in the South African Companies Act. For present purposes it suffices to say that the South African Companies Act defines a 'director' as a 'member of the board of a company'.[818] The board, in turn, is that entity which must manage the business and affairs of a company, and that has the authority to exercise all of the powers and perform any of the functions of the company.[819] While the Companies Act's definition does not specifically distinguish between 'executive' and 'non-executive' directors, it is clear that the distinction continues to exist. The Companies Act, for instance, requires public companies to have audit committees whose members must be directors who are independent and non-executive.[820] In the words of the Act, the directors who are members of audit

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[814] Section 77(a)(ii) of the Act.
[815] Section 77(a)(i) of the Act.
[816] Section 77(a)(ii) of the Act.
[817] The market abuse section of the Act does contain a definition of 'executive director'. The term is defined to mean a 'person appointed as such in terms of section 85(12)'. Section 85(12) deals with the composition of the Directorate of Market Abuse and is irrelevant for present purposes.
[818] Section 1 of the Companies Act 71 of 2008.
[819] Section 66(1) of the Companies Act 71 of 2008.
[820] Section 94(4) of the Companies Act 71 of 2008.

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committees must 'not be . . . involved in the day-to-day management of the company's business or have been so involved at any time during the previous financial year',[821] they must 'not be . . . a prescribed officer, or full-time employee, of the company or another related or inter-related company, or have been such an officer or employee at any time during the previous three financial years',[822] must 'not be . . . a material supplier or customer of the company, such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship',[823] and must not be 'related to any person who falls within' any of those descriptions.[824]

'Director', as that term is used in the Financial Markets Act, therefore includes executive and independent non-executive directors. Both types of director are subject to the prohibitions against insider trading. This is in keeping with the United States approach.[825] The enactment of legislation such as the Sarbanes Oxley Act[826] puts onerous duties on non-executive directors, including members of audit committees, increases the likelihood of their learning inside information, and requires them to be recognised as insiders.

In *SEC v Happ*,[827] Happ, an audit committee member and a non-executive director, was found guilty of insider trading. Just before the end of a company, Galileo's, third fiscal quarter, two executive directors, Gregory and Hanley, met to discuss its financial difficulties. They decided to seek Happ's advice. Hanley phoned Happ. Although he could not reach Happ directly, he left two voicemail messages. The gist of Hanley's voicemails was that the company was having some difficulties in the third quarter and that he wanted to meet with Happ. Happ, after

[821] Section 94(4)(b)(i) of the Companies Act 71 of 2008.
[822] Section 94(4)(b)(ii) of the Companies Act 71 of 2008.
[823] Section 94(4)(b)(iii) of the Companies Act 71 of 2008.
[824] Section 94(4)(c) of the Companies Act 71 of 2008.
[825] See *Langevoort on insider trading* (Rel 7 4/2009) 3–5 at note 1.
[826] The Sarbanes-Oxley Act of 2002 Pub.L. 107–204, 116 Stat. 745, enacted July 30 2002.
[827] 392 F 3d 12 (1st Cir 2004).

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having phoned Hanley's assistant to schedule a meeting, sold all of his shares in the company. Two days later Galileo issued a press release making public their financial difficulties. While Galileo had forecast net profits of $160 000 for the quarter, it had to report losses of $3.3 million. The day after the announcement, Galileo's stock price fell by 63%. The court *a quo* found Happ guilty of contravening Rule 10b-5. He was ordered to pay a disgorgement for the losses he avoided and an additional sum as a civil penalty.[828] His appeal failed.[829]

Does the Financial Markets Act's definition of insiders include only directors that are in the employ of a company at the moment when they perpetrate the prohibited conduct? The words used in the definition of insider are open to the interpretation that, even though a person receives inside information as a director, she would not be an insider if she perpetrates the prohibited conduct after her directorship ends. The ambiguous phrases are 'through . . . being a director', 'through having access to such information by virtue of employment' and 'through having access to such information by virtue of . . . office'.[830] Not only would this interpretation be irreconcilable with a regulatory regime based on the equal access to information theory, it would be irreconcilable with the objectives of the Financial Markets Act, specifically to 'ensure that the South African financial markets are fair, efficient and transparent' and to 'increase confidence in the financial markets'.[831] Those objectives will not be served by an arbitrary legislative line between incumbent directors with inside information and former directors with inside information, that will prohibit only incumbent directors from dealing with the information. Circumventing the insider trading prohibition cannot be made as easy as to simply relinquish one's post as a director. A purposive interpretation of the definition leaves directors who obtain inside information through being directors liable for insider trading notwithstanding the fact that they are no longer directors when they commit the statutory offence. That is the interpretation which must obtain. Even in strictly fiduciary doctrine and

[828] See *SEC v Happ* 295 F Supp 2d 189 (D Mass 2003) 200.
[829] *SEC v Happ* 392 F 3d 12 (1st Cir 2004) 35.
[830] Section 77(a) of the Financial Markets Act.
[831] Section 2(a) and (b) of the Financial Markets Act.

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misappropriation-based jurisdictions it does not matter whether the person with inside information was no longer a director at the time when she traded with the inside information.

In *US v Causey and Others*[832] the charges arose out of the Enron debacle. More specifically, they were born out of the now well-known scheme designed to deceive the investing public, including Enron's shareholders, the SEC, and others, about the true performance of Enron's business. The defendants, Causey, Lay and Skilling, served respectively as chief executive officer, chief operating officer, and chief accounting officer in the corporation. Causey and Skilling both had to answer to many charges, including several counts of insider trading. It was alleged that they knew of the misleading portrayal of Enron's financial position, that its share price was inflated, and that its credit rating painted an inaccurate picture of the company's ability to service its debts. They sold their Enron shares and passed on the losses to an unsuspecting public before the corporation's true financial position was made public and its share price collapsed.

Skilling moved to have one of the counts of insider trading against him struck out as the trade in question had occurred after he had resigned as chief executive officer. The court dismissed his motion. It reasoned that Skilling's duty to refrain from trading on inside information, flowing from the fiduciary duty he owed to Enron's shareholders, did not cease upon his resignation. Indeed, found the court, the duty continued to be owed for as long as the information remained inside information.

Manne argues that directors of issuers, whether non-executive or executive directors, should be allowed to trade on inside information as the inside information profits they earn provide an important component of executive compensation.[833] Inside information would allow

[832] *US v Causey and Others* (Unreported) Case no H-04-025-SS (29 December 2005).

[833] Manne (2005) *J Corp L* 170. Also see Manne (2005) *J Corp L* 171 and the discussion of stock options as remuneration for directors and managers. The timing of the exercise of the option will undoubtedly

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executives to set and adjust their own rewards quickly. In this way, so the argument goes, inside information could contribute to reducing the costs of the renegotiation of their remuneration, as the renegotiation is rendered unnecessary.[834] Manne is not alone in making this point. Carlton and Fischel agree that insider trading may present a solution to 'the cost of renegotiation dilemma'.[835]

The argument is based on the premise that managers are agents whose actions cannot be perfectly monitored by security holders. Managers have the ability and the incentive to act in their own interest rather than in the interest of the firm.[836] They, for instance, have room to have a company pursue investment projects that would maximise their personal benefit rather than that of the firm. The natural safeguards, which ensure that managers' and security holders' interests are not completely misaligned, are imperfect. These safeguards are protective mechanisms found in various markets, including the markets for managerial positions, for corporate control, for products and services, and for securities. Rational shareholders, for instance, offer less for shares exposed to irresponsible management. This, in turn, limits the managers' compensation because the lower the value of the shares of the companies they manage, the less the managers would be able to charge for their services.[837] So too does the market for managerial positions provide redress where managers are overcompensated. A bad track record has a negative effect on a person's ability to negotiate a compensation package at a new firm. As these markets do not, however, function perfectly, room remains for managers to shirk their responsibility to act in a way other than in the firm's best interest, without penalty.[838] There is therefore an incentive on the part of both managers and security holders to reach agreements that align their interests.[839] Reaching these types of

be influenced by information that is to a certain extent, inside information. Also see D W Carlton & D R Fischel "The Regulation of Insider Trading" (1983) 35 *Stan L Rev* 857 861.

[834] Carlton & Fischel (1983) *Stan L Rev* 861.
[835] Ibid. 870–871.
[836] Ibid. 869.
[837] Ibid. 869.
[838] Ibid.
[839] Ibid. 869–870.

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agreements are costly. They have to be renegotiated often. They are also subject to a shareholder asymmetry of information.

To allow managers to trade on inside information is to provide a solution to this problem.[840] Carlton and Fischel argue that it will incentivise managers to pursue valuable opportunities benefiting the firm. As a manager has the opportunity to trade in his firm's securities before a rise in the value of a security, she will have an incentive to engineer events that produce valuable information. Trading on inside information has, therefore, the ability to align management's interests with those of their incumbent shareholders, who will also benefit from these events.[841] When managers or directors are successful in doing so, the company's shares will increase in value and their prices will rise, allowing directors and management the opportunity to earn insider trading profits as they can trade before the information is made public. Directors and management's remuneration is therefore automatically increased when their companies' achieve corporate successes. What is said to be a lengthy and costly remuneration renegotiation process is avoided. As Carlton and Fischel put it, 'the manager, in effect, renegotiates each time he trades.'[842] The ability to trade on inside information is therefore put forward as a mechanism to reduce corporate agency costs.[843]

Haddock and Macey argue also that allowing directors to trade on inside information (and in the process, set their own compensation) is to allow the production of market information at a low cost.[844] The authors premise their argument on the fact that there are mainly two sets of providers of information to 'complete outsiders' (ordinary traders without any access to inside or even very recent information): 'true insiders' (managers and directors) and market

[840] Ibid. 871.
[841] Ibid.
[842] Ibid. 870.
[843] Ibid. 870–871.
[844] D D Haddock & J R Macey "Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation" (1987) 30 *JL & Econ* 311 318.

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professionals.[845] True insiders have access to information as a result of their employment or the office they fill. They have access to new firm-specific information, which enables them to buy securities while having an information advantage. If regulatory measures were to deny them that opportunity, the rents will just be moved on to the second group, the market professionals. Market professionals spend their careers perfecting methods to obtain information about certain firms or industries and to evaluate that information.[846] After an evaluation, they put the information to use in executing speedy market transactions before other traders drain the information of its value.[847] True insiders, on the other hand, are dealing with the information they impart to the market directly: they receive the information, trade on it, and it is incorporated into the security's price. True insiders do not expend resources to gather information; they provide information at a low cost to the market.[848] It follows, say the authors, that allowing inside information trading by primary insiders or directors is to allow outsiders, those traders other than insiders or market professionals, access to low cost information. Not to allow it, would be to increase the price of information to outsiders. In other words, whereas allowing insider trading by directors may work against market professionals, it works to the benefit of outsiders.[849]

The arguments for allowing directors and management to trade on inside information are met with strong opposition.[850] This is the result of the fact that the profits offered by trading on

[845] Haddock & Macey (1987) *JL & Econ* 317.
[846] Ibid. 318.
[847] Gilson & Kraakman (1984) *Va L Rev* 571–572.
[848] Haddock & Macey (1987) *JL & Econ* 318.
[849] Ibid.
[850] J D Cox "Insider Trading and Contracting: A Critical Response to the 'Chicago School'" (1986) 1986 *Duke LJ* 651–652; F H Easterbrook "Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information" (1981) 1981 *Sup Ct Rev* 309 332; R J Haft "The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation" (1981–1982) 80 *Mich Law Review* 1053-56; Schotland (1967) *Va L Rev* 1435.

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inside information would not be subject to the normal constraints put on management when they determine or renegotiate their compensation.[851]

In South African company law, for instance, a company may pay remuneration to its directors only in accordance with a special resolution approved by the shareholders or in terms of the company's memorandum of incorporation.[852] It is a recognition that directors and managers must not have the power, outside of the company's founding documents and its shareholders' approval, to determine their own compensation.[853] To give directors and managers the right to trade on inside information would be to allow them to circumvent the constraints of a formal bargaining process. While this may lower transaction costs, it would be detrimental to the oversight role shareholders (including institutional investors) are able to play in the bargaining process. Managers will also consequently be incentivised to rather earn their remuneration through trading with inside information than through more formal methods of compensation. Why would they go to the trouble of negotiating and justifying higher earnings, whether it be to shareholders, creditors or perhaps even the public in general, when they could simply raise their income by increasing their trades with inside information? In addition, and in any event, even if directors would go to the trouble of somehow disclosing their insider trading profits to their security holders, insider trading as a compensation mechanism would be 'ripe with informational asymmetries' between shareholders and management.[854] To allow managers to trade on inside information is to allow them a way of compensating themselves, about which shareholders (or anyone else for that matter) have very little information and therefore very little control.

Insider trading, as a means to compensate management, also does not necessarily align shareholders' interests with that of management.[855] If directors are allowed to trade on inside

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[851] Easterbrook (1981) *Sup Ct Rev* 333.
[852] Section 66(8) read with section 66(9) of the Companies Act 71 of 2008.
[853] R C Clark *Corporate Law* (1986) 273.
[854] Cox (1986) *Duke LJ* 657.
[855] Ibid. 658.

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information and to set their own compensation, managerial performance, objectively assessed, is no longer the determinant of compensation. Management, setting their own compensation, will be in a position to reward themselves in ways bearing no relation to their performance. Whereas management should be focused on maximising their shareholders' return and growth in their equity, their focus would instead be on seeking profits from trading on inside information.[856]

For instance, the opportunity to gain from insider trading may induce managers to increase the volatility of the firm's stock prices.[857] They may also become prone to higher risk investment as higher risk investments and volatile stock prices offer them the opportunity to quickly realise high returns. Should the risk pay off, they would be in a position to capture a portion of the gains through insider trading. If the project flops, management will be able to avoid the losses consequent upon their failures by, as Enron showed, selling their shares before information detrimental to the prices of their companies' securities is made public, whereas their investors would have to suffer all the losses.[858]

The prospects of earning insider trading profits also create the incentive for managers to delay the release of information at a cost to the firm.[859] Firms incur expenses to protect valuable information. A delay in disclosure means the firm has to protect the valuable inside

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[856] Easterbrook (1981) *Sup Ct Rev* 332–333 and Cox (1986) *Duke LJ* 659.

[857] Easterbrook (1981) *Sup Ct Rev* 333.

[858] Schotland (1967) *Va L Rev* 1453. Manne, at 102, was of the opinion that:

> There are reasons to assume that good news is more important than bad news for our purposes. First the long-term trend of stock prices is upward, so that, all other things being equal, occasions of good news should exceed those of bad. Perhaps more important, substantial good news seems often to develop quickly, as with the news of a new product, a favorable merger offer or an important government contract. Bad news on the other hand tends to unfold in a more gradual fashion, or perhaps to be anticipated, as with a low earnings report or a dividend cut. Bad news may also more frequently be information affecting an entire industry and thus not be susceptible to insider trading at all.

[859] Ibid. 334. Also see D Ferber "The Case Against Insider Trading: A Response to Professor Manne" (1970) 23 *Vand L Rev* 621 623.

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information for longer. This additional cost of protecting information may not have a large effect, especially as firms expend resources on protecting information in the normal course,[860] but it illustrates that when management pursues its insider trading objectives, the efficient operation of the firm suffers.[861] Company resources are diverted from legitimate destinations and used for personal gain.[862]

Insider trading is also an inefficient form of compensation as there is no reason why the compensation would bear any relation to the size of the director's investment of time and labour in the firm.[863] It would be difficult to isolate, and consequently properly evaluate and gauge, the managerial contribution. How valuable was the director's contribution? How much trading on inside information should she be allowed? It is, in addition, highly doubtful that the profits from insider trading would compensate the person responsible for adding value to the company. For example, where a revolutionary product is developed, the discovering scientist (probably an employee under a contractual obligation to surrender her ideas to the company, whose remuneration is limited to her salary) would be much less likely to benefit from the insider trading profits, than the manager in control of the research and development department the employee works in, or the director of the company the employee works for.[864]

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860 Easterbrook (1981) *Sup Ct Rev* 334.

861 Schotland (1967) *Va L Rev* 1452.

862 Cox (1986) *Duke LJ* 659.

863 S Bainbridge "The Insider Trading Prohibition: A Legal and Economic Enigma" (1986) 38 *U Fla L Rev* 46–49.

864 Schotland uses the apt example of the once 'supremely innovative' inventor and the head of research for the American motor vehicle production company, General Motors, Mr Charles Kettering. Kettering, notwithstanding the fact that he was a brilliant inventor in a company at the forefront of the motoring revolution, was said to have lost money in making his investments as he had always been 'unable to attend meetings, and said that he did not understand investments; adding, what interested me greatly, that he saw life through [a] laboratory window'. Testimony of Judge Healy, and SEC member, in the Hearings on Investment Trusts and Investment Companies before the Senate Banking & Currency Committee 1940 as cited by Schotland (1967) *Va L Rev* 1456 at note 86.

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The considerations weighing against an insider trading compensation system are further not limited to directors' and management's ability to overcompensate themselves. Nothing is to say that insider trading profits would be able to compensate them sufficiently when they perform well, securing the optimal levels of return and expansion for the corporation and its shareholders.[865] The amount of remuneration a director or manager is able to earn would rather be a function of their financial ability at the time that they receive the inside information and their ability to put the information to use.[866] There are therefore restraints on a manager's ability to earn profits from trading on inside information: she has limited resources; she has limited knowledge of the overall health of the corporation; there could be an infrequency of events significant enough to trade on; she may not be able to act quickly enough to realise her deserved rents; and, perhaps rather less likely, she may suffer from ethical compunctions, which would restrain her in compensating herself sufficiently.[867]

4 3 1 2 Shareholders

The Financial Markets Act recognises as insiders persons who have inside information through being shareholders of issuers of securities listed on a regulated market to which the inside information relates or of derivative instruments related to such securities to which the inside information relates.[868] The same language that is used for employees and directors, is used for shareholders. By a parity of reasoning, former shareholders are insiders, as former directors are insiders. There is empirical evidence that the owners of large blocks of shares more often trade with inside information than any other type of market participant.[869] There is also a correlation between the incidence of insider trading by shareholders and the firm specific risk

[865] Schotland (1967) *Va L Rev* 1430. This is acknowledged by Manne himself. (Manne (2005) *J Corp L* 173).
[866] M Mendelson "The Economics of Insider Trading Revisited" (1969) 117 *U P L Rev* 470 488.
[867] Schotland (1967) *Va L Rev* 1430.
[868] Section 77(a)(i) of the Act.
[869] H Demsetz "Corporate Control, Insider Trading, and Rates of Return" (1986) 76 *Am Econ Rev* 313 314.

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they are exposed to. In other words, the higher investors' exposure to a certain firm, the more likely it is that those investors will trade on inside information about that firm.[870] The Act does not, however, distinguish between minority, majority or other types of shareholders. They are all included within the definition.

Demsetz argues that specifically controlling shareholders should be allowed to trade on inside information. He emphasises the role concentrated ownership plays in monitoring management.[871] Insider trading profits are said to be effective compensation to controlling shareholders for the higher risk they take as a result of being less diversified and because they perform important monitoring functions.[872] The argument is similar to Manne's executive compensation argument.[873] It fails to convince for some of the same reasons.

It would be impossible to measure accurately the controlling shareholders' contribution to the firm and to ensure that their reward is commensurate with their contribution. In addition, if the legislature were to allow controlling shareholders to trade on inside information, how would it ensure that sharing of information is to happen only among the controlling shareholders? Once some economic actors are allowed to trade with inside information, it would be very difficult to stop others from doing so. To allow specifically the holders of big blocks of shares to trade on inside information, would also provoke conflicts between groups of shareholders.[874]

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[870] Ibid. 315.
[871] Ibid. 315.
[872] Ibid.
[873] Manne (2005) *J Corp L* 169. A term used by the author to describe his own argument thirty-nine years after he first made it.
[874] E Maug "Insider Trading Legislation and Corporate Governance" (2002) 46 *Eur Econ Rev* 1569 1570.

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It would leave small investors with smaller shareholdings vulnerable.[875] Maug argues that in an environment where people are free to trade on inside information, dominant shareholders will collude with management to share inside information between them. The author provides an example of managers warning the company's major shareholders in advance of negative developments in the company, urging those shareholders to sell their shares at higher prices rather than seeking to intervene in the running of the company.[876] This is, of course, beneficial to those shareholders, as it allows them to realise the higher selling price before the market price incorporates the negative information. Profits from insider trading become the opportunity costs of monitoring and intervention.[877] As long as the profits are sufficiently lucrative, management remains free to run the company, protecting larger shareholders' interests. In other words, managers, in an environment where insider trading is not regulated, are free to use inside information to render the controlling shareholders beholden to them. This type of conduct has been described as the 'dark side of shareholder activism'.[878] To align smaller shareholders' interests with those of dominant shareholders, dominant shareholders must be prohibited from trading with inside information.[879]

In the United States, as in South Africa, controlling shareholders are recognised as insiders. In the United States the basis for their liability is an extension of directors' fiduciary obligations. The reasoning is that controlling shareholders also control corporate activity, which affects the shares of others, as a result of the size of their shareholding.[880] In addition, it is said that it is fair also to hold controlling shareholders liable as insiders as they have the same type of access to inside information as would an officer or director of the company. This approach was adopted by the Delaware District Court in 1951 in *Speed v Transamerica*

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[875] Ibid. 1572.
[876] Ibid. 1570.
[877] Ibid.
[878] Ibid.
[879] Ibid. Also see E B Rock "Controlling the dark side of relational investing" (1994) 15 *Cardozo L Rev* 987.
[880] *Langevoort on insider trading* (Rel 7 4/2009) 3–5.

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Corp.[881] Transamerica was a dominant shareholder of a company that manufactured tobacco products, Axton-Fisher. Speed, who sold Axton-Fisher shares to Transamerica, alleged that Transamerica was in a process of buying out other shareholders in an effort to earn more in relation to an increase in the value of leaf tobacco that Axton-Fisher had in stock.

The court put majority shareholders of issuers on par with officers and directors. It held that a majority shareholder, just like an officer or director, occupies an inside position. In dealing with Rule 10b-5, the court held as follows:

> The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority shareholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take advantage of the uninformed minority stockholders.[882]

Non-controlling shareholders are not treated as owing fiduciary duties, unless they step into some additional fiduciary relationship or if they are tippees. In *Feldman v Simkins Industries Inc*[883] a shareholder, although having inside information in his possession, was not regarded as an insider for the reason that he had only a 14% shareholding. Between 1974 and 1977 Simkins acquired 14% of a company called Fibreboard Corporation. Simkins became convinced, however, that Fibreboard was poorly managed. The president of Simkins and the Fibreboard management had also become openly hostile toward each other. Simkins sold to Feldman his shares in Fibreboard. Feldman instituted an action against Simkins, but he failed to show that Simkins was an insider.[884] As a starting point the court recognised that insider status is normally reserved for officers, directors, and controlling shareholders of the corporation, and for those having some kind of special relationship with the corporation that affords them access

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[881] 99 F Supp 808 (D D 1951).
[882] Ibid. 828–829.
[883] 679 F 2d 1299 (9th Cir 1982).
[884] Ibid. 1303.

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to inside information. Emphasising that in determining insider status, one should ask whether a person has access to confidential information intended to be available only for a corporate purpose, the court found that Simkins was not an insider.[885]

SEC v Talbot[886] highlights the tension, present also in South African law, between holding shareholders liable for insider trading, and the fiduciary duty doctrine. The tension is found in the anomaly that, once it is accepted that shareholders owe a duty to the issuer, it becomes rather more difficult to explain how they could also be beneficiaries of a fiduciary relationship between themselves and true fiduciaries. The court in *Talbot* held that shareholders are not to be held liable for insider trading as they did not owe a fiduciary duty, 'rather, [they were] owed such a duty'.[887]

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885 Ibid. 1304.
886 430 F Supp 2d 1029 (CD Cal 2006).
887 Ibid. 1051.

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4 3 1 3 Employees

Subsection (a)(i) of the definition of insider in the Financial Markets Act, includes employees of issuers of securities listed on regulated markets or issuers of derivative instruments related to such securities to which the inside information relates, who have the inside information 'through being' employees.[888] Subsection (a)(ii) includes persons who have inside information 'through having access to such information by virtue of employment'.[889] As most of the professions, including law, accounting and medicine, can be practised as an employee,[890] the two terms 'through . . . employment' and 'through . . . profession' overlap considerably.

Employment, as used in the subsection, is to be given its ordinary meaning, which is 'the state of having paid work.'[891] As the legislature has chosen not to limit the definition to 'employees', but rather to include persons who have information by virtue of their 'employment', the definition covers persons working under contracts of service (*locatio conductio operarum*) and contracts in which one person undertakes to perform or execute a particular piece of work to produce a certain specified result (*locatio conductio operis*). A purposive interpretation of the definition would, as is the case with directors and managers, include former employees who learned inside information during their employment. The (a)(i) subcategory covers issuer's employees such as those in *SEC v Texas Gulf Sulphur*[892] who traded in the securities of their employer (the issuer) because they knew (to the exclusion of the market) that it had discovered rich mineral deposits on a piece of land it was about to

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[888] Section 77(a)(i) of the Act.
[889] Section 77(a)(ii) of the Act.
[890] S L Buhai "Profession: A definition" (2012) 40 *Fordham Urb LJ* 241 281.
[891] Soanes & Stevenson *Oxford Dictionary of English*.
[892] See par. 2 2 3 2 above.

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purchase. The (a)(ii) subcategory covers, for instance, parties such as the defendant in *SEC v Materia*.[893]

The case dealt with an employee not employed by an issuer, but working at a New York City firm specialising in the printing of financial documents. These documents included many used in connection with takeovers by its corporate clients. The firm went to great lengths to guard the confidential information with which it dealt: code names were used, blanks were left, and misinformation was included in documents from time to time. This did not, however, deter Materia. Within hours of learning inside information, he would purchase stock and within days of a tender offer being made public, he would sell the stock. The court *a quo* found that Materia had breached a duty to his employer and its clients.[894] The court of appeal upheld this finding. The court of appeal further held that a financial printer's most valuable asset is its reputation as a safe repository for its clients' secrets. By stealing these secrets from his employer, Materia was said to have undermined his employer's integrity and was guilty of insider trading.[895] In the United States, one of the more common manners of founding liability under the misappropriation theory is to establish a breach of an employee contract.

The South African definition of insider does not distinguish between lower- and higher-level employees. The definition therefore includes all levels of employees and someone such as the secretary in *SEC v Falbo*,[896] who obtained inside information in helping her husband, an electrician, to steal the information of the company for which she was working. The Financial Markets Act cannot be faulted for including employees of all levels within the definition. In large corporations information passes through several layers in the corporation's hierarchal structure before it reaches the decision makers who rely on the information. To allow insider trading in the corporation's structure (below management) would impair corporate decision

[893] 745 F 2d 197 (1984).
[894] Ibid. 200.
[895] Ibid. 202.
[896] See par. 2 2 3 9 above.

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making at all hierarchal levels.[897] If lower level employees are allowed to trade on inside information, there is a potential for information to get distorted.[898] The insiders at every level, as information rises through the hierarchal structure, would trade on the information and hold onto it for as long as possible, to delay their fellow insiders from trading on the information, thereby maximizing their own gains.[899] The employee at each level would not be able to effect too much of a distortion or delay, as this would have disciplinary consequences.[900] However, it is the total delay and distortion brought about, if one considers the intricate and multiple layered nature of the modern corporation, that rebuts the argument that employees should be allowed to trade with inside information.

4 3 1 4 Professionals

Subsection (a)(ii) of the Act recognises as insiders persons who have inside information through having access to such information by virtue of their 'profession'.[901] Seen in isolation, the term has a vaguely delineated meaning.[902] In the Act, it is found after 'employment' and 'office'.[903] The Act, however, does not provide any assistance in distinguishing between those three terms. The Constitution recognises the distinction between a 'trade', an 'occupation' and a 'profession',[904] but it also does not assist in distinguishing between those terms.

The Oxford Dictionary of English defines 'profession' as a 'paid occupation, especially one that involves prolonged training and a formal qualification'.[905] Sociologists, however, argue

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[897] Ibid. 1054.
[898] Haft (1982) *Mich L Rev* 1053.
[899] Ibid. 1055.
[900] Ibid. 1057.
[901] Section 77(a)(ii) of the Act.
[902] R A Posner "Professionalisms" (1998) 40 *Ariz L Rev* 1 1.
[903] Section 77(a)(ii) of the Act.
[904] See section 22 of the Constitution.
[905] Soanes & Stevenson *Oxford Dictionary of English*.

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that the word has little value for distinguishing among analytically different types of occupations except insofar as it confers a mark of social prestige or status.[906] South African case law is equally unhelpful. One South African judgment, *Die Prokureursorde van die Oranje-Vrystaat v Schoeman*, recognises that the term is open to a broad and a narrow interpretation.[907] According to the narrow interpretation, a profession is a vocation in which a professed knowledge of some department of learning is used in its application to the affairs of others, or in the practice of an art founded upon it. This interpretation includes law and medicine. The broad interpretation includes any calling or occupation by which a person habitually earns his living.[908]

The author Buhai made a useful study of the professions of law, accounting and medicine to identify their common characteristics.[909] The author concludes that:

> Each profession provides a service that requires specialized education and the exercise of independent judgment. They all have substantial expertise that reveals the disparities in the information available to the professional and the client, and therefore the client's ability to trust the professional is essential. Each requires its professionals to put someone else's interests ahead of their own and therefore requires an ethos different from business's standard profit maximization norm. Such an ethos supports internalized codes of conduct and occupational self-regulation. Finally, they all have duties to the public in addition to duties to their individual clients.[910]

An important element to consider in distinguishing the professions from other occupations or normal employment (found under what Buhai calls 'internalized codes of conduct and occupational self-regulation') is control: who controls or commands the determination of what work shall be done by the members of the profession and how that work shall be performed or

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[906] E Freidson "Theory and the Professions" (1989) 64 *Ind LJ* 423.
[907] *Die Prokureursorde van die Oranje-Vrystaat v Schoeman* 1977 (4) SA 588 (O) 592–594.
[908] Ibid. 592.
[909] S L Buhai "Profession: A definition" (2012) 40 *Fordham Urb LJ* 241 281.
[910] Ibid. Also see M C J Bobbert "Advertising of Attorneys' Services in South Africa" (1986) 103 *S African LJ* 461 465 referred to in *Prokureursorde van die Oranje-Vrystaat v Schoeman* 1977 (4) SA 588 (O) 592.

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evaluated?[911] Control, in respect of professions, normally lies in a near-exclusive jurisdiction by members of the occupation over particular tasks so that only they have the right to perform them.[912] A certification by an accepted agent representing the occupation that approved training was successfully completed is therefore a common prerequisite for being admitted into a profession.[913]

Posner identifies a set of occupations most commonly referred to as professions and occupations that are not commonly referred to as professions. Apposite examples of the former are law, medicine (and its related fields), engineering, the clergy, teaching, architecture, actuarial services, librarianship, social work, journalism and accounting.[914] Apposite examples of the latter are business management, business generally, advertising, public relations, farming, politics, fiction writing, the civil service, entertainment, construction (other than architecture and engineering), police and detective work, computer programming, and the majority of positions of employment in transportation.[915] Considering the context of the definition of insider, stockbrokers and other financial market practitioners regulated by the South African Institute of Stockbrokers and the South African Institute of Financial Markets, are to be included in Posner's list of professions.

Some professionals have better access to inside information than other market participants. Mergers and takeovers, for instance, provide professionals, including lawyers and accountants, and firms housing professionals, access to inside information. In *SEC v Clark*,[916] Clark was the president of Rolyan Manufacturing Company. It sold medical supplies. A London based multinational corporation, Smith & Nephew, acquired Rolyan, but kept Clark as president. After having acquired Rolyan, Smith & Nephew resolved to take over other medical supply

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[911] E Freidson "Theory and the Professions" (1989) 64 *Ind LJ* 423 425.
[912] Ibid. 426.
[913] Ibid.
[914] R A Poser "Professionalisms" (1998) 40 *Ariz L Rev* 1–2.
[915] Ibid.
[916] 915 F 2d 439 (9th Cir 1990) 453 and footnote 26.

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manufacturers in North America. It employed an acquisitions team to look for promising takeover targets. Clark was a member of this team. He attended regular meetings to discuss possible candidates for acquisition. The team members were aware of the fact that Smith & Nephew considered all information about takeovers as confidential and that the company forbade the disclosure or personal use of any of the information. Clark became aware of a company that Smith & Nephew was interested in purchasing. He learned how much they intended to offer for the shares and how much the shares were worth at that point. He instructed his stockbroker to purchase 2 000 of the shares of the target company. He also instructed his stockbroker to hide his trading from Smith & Nephew. The trading would be done under Clark's wife's maiden name. After the takeover bid was made public, Clark sold his shares and realised a substantial profit. The SEC instituted action and he was held liable under the misappropriation theory. On appeal, Clark argued that the misappropriation theory did not apply to his case. The court, however, affirmed the use of the misappropriation theory for employees and found Clark guilty of having misappropriated information from his employer.

In *United States v Newman*,[917] an employee of an investment bank was held guilty of insider trading. Morgan Stanley & Co and Kuhn, Loeb & Co, today better remembered as Lehman Brothers, were investment banks who represented companies in corporate mergers, acquisitions, tender offers, and other takeovers. One Courtois and a co-conspirator not before the court, Antoniu, had been employed by Morgan Stanley. Antoniu left Morgan Stanley and joined Kuhn Loeb. For not less than five years, Courtois and Antoniu stole confidential information concerning proposed mergers and acquisitions that was entrusted to their employers by corporate clients. This information was conveyed surreptitiously to Newman, a securities trader and manager of the over-the-counter trading department of a New York brokerage firm.

[917] 664 F 2d 12 (1981).

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Newman passed along the information to Carniol and Spyropoulos. Carniol was a resident of Belgium and Spyropoulos was a Greek who lived in both Greece and France. Using secret foreign bank and trust accounts and spreading their purchases among different brokers to avoid detection, the three purchased stock in companies that were merger and takeover targets of clients of Morgan Stanley and Kuhn Loeb. They realised their gains when the takeovers were announced and the market price of the stocks rose. The profits were shared with Courtois and Antoniu. The charges alleged that Courtois and Antoniu breached the trust and confidence placed in them and their employers by the employers' corporate clients and the clients' shareholders, and the trust and confidence placed in the two by their employers. Courtois, Newman, and Carniol were furthermore charged with having aided and participated in violating the fiduciary duties of 'honesty, loyalty and silence' owed to Morgan Stanley, Kuhn Loeb, and the clients of those investment banks.[918]

The court held that Newman's conduct constituted a criminal violation of section 10(b) and Rule 10b-5 despite the fact that neither Morgan Stanley, Kuhn Loeb, nor their clients were at the time a purchaser or seller of the target company securities in any transaction with Newman.[919] The court held:

> Had [Newman] used similar deceptive practices to mulct Morgan Stanley and Kuhn Loeb of cash or securities, it could hardly be argued that those companies had been defrauded. . . . By sullying the reputations of Courtois' and Antoniu's employers and safe repositories of client confidences, appellee and his cohorts defrauded those employers as surely as if they took their money. . . . [Newman] and his cohorts also wronged Morgan Stanley's and Kuhn Loeb's clients, whose takeover plans were key to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information.[920]

[918] Ibid. 16.
[919] Ibid.
[920] Ibid. 17.

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United States' Rule 14e-3 was promulgated to specifically prohibit trading on inside information in the context of mergers and takeovers.[921] The Rule's prohibitions are additional to those promulgated under Rule 10b-5.[922] Prosecutions have been instituted alleging violations of both the rules where the conduct not only amounted to a breach under Rule 14e-3, but also to a misappropriation of confidential information under Rule 10b-5.[923] Rule 14e-3 provides:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14e of the Act for *any other person* who is in possession of material information relating to such tender offer which information he knows or has reason to know is non-public and which he knows or has reason to know it has been acquired indirectly from:
>
> (1) The offering person,
>
> (2) The issuer of the securities sought or to be sought by such tender offer, or
>
> (3) Any officer, director or partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities convertible or exchangeable for any such securities or any option or right to obtain or to dispose of any foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.
>
> (b) A person other than a natural person shall not violate paragraph (a) of this section.[924] (Emphasis added.)

[921] For discussions of this rule, see B G Stahl "Rule 14e-3: Invalid in the Criminal Context" (1988) 16 *Am J Crim L* 367; E L B Haskell "'Disclose-or-Abstain' Without Restraint: The Supreme Court Misses the Mark on Rule 14e-3 in United States v. O'Hagan " (1998) 55 *Wash & Lee L Rev* 1055; J Lobb "SEC Rule 14e-3 in the Wake of United States v O'Hagan: Proper Prophylactic Scope and the Future of Warehousing" (1998) 40 *William & Mary Law Review* 1853; W J Cook "From insider trading to unfair trading: Chestman II and Rule 14e-3" (1992) 22 *Stetson Law Review* 171; S Thel "Statutory Findings and Insider Trading Regulation" (1997) 50 *Vand L Rev* 1091; M F Hill "Trading on Material Non-public Information under Rule 14e-3" (1981) 49 *George Washington Law Review* 539; and T L Hazen "United States v Chestman – Trading in Securities on the Basis of a Nonpublic Information in Advance of a Tender Offer" (1991) 57 *Brooklyn L Rev* 595.

[922] See *Langevoort on insider trading* (Rel 7 4/2009) 7-2 footnote 2.

[923] See *SEC v Maio* 51 F 3d 623 (1995) and *SEC v Musella* 578 F Supp 425 (1984).

[924] The rule goes on to create certain exceptions for corporations. Rule 14e-3(b) provides:

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A person other than a natural person shall not violate paragraph (a) of this section if such person shows that:

(1) The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) of this section or to cause any such security to be purchased or sold by or on behalf of others did not know the material non-public information;

(2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a) of this section, which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

The rule also makes certain exceptions for specific types of transactions. Rule 14e-3(c) provides:

Notwithstanding anything in paragraph (a) of section 14 to the contrary, the following transactions shall not be violations of paragraph (a) of this section:

(1) Purchase(s) of any securities described in paragraph (a) of this section by a broker or by another agent on behalf of an offering person; or

(2) Sale(s) by any person or any security described in paragraph (a) of this section to the offering person.

The rule provides expressly that tipping shall be unlawful in certain circumstances, Rule 14e-3(d) provides:

(1) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, non-public information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section except that this paragraph shall not apply to a communication made in good faith.

(i) To the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer, or

(ii) To the issuer whose securities are sought or to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other purposes, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer, or

(iii) To any person pursuant to a requirement of any statute or rule or regulation promulgated hereunder.

(2) The persons referred to in paragraph (d)(1) of this section are:

(i) The offering person or its officers, directors, partners, employees or advisors;

(ii) The issuer of the securities sought by such tender offer or its officers, directors, partners, employees or advisors;

(iii) Anyone acting on behalf of the persons in paragraph (d)(2)(i) of this section or the issuer or persons in paragraph (d)(2)(ii) of this section; and

(iv) Any person in possession of material information relating to a tender offer which information he knows or has reason to know is non-public and which he knows or has reason to know has been acquired directly or indirectly from any of the above.

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The United States' legislature has therefore decided that, in the context of mergers and acquisitions, an individual's liability is determined with reference to what he knows rather than who he is. There is no breach of duty requirement, although knowledge of the information's source is a prerequisite for liability. If 'any' person trades while in possession of material non-public information (in connection with a tender offer by another party), she may be subject to prosecution for insider trading under Rule 14e-3.

As opposed to the United States Supreme Court's reluctance in accepting the equal access to information theory, Congress has recognised equal access as necessary, at least in certain specific factual scenarios. This is important in at least two respects. Firstly, it shows that whereas in the main, the jurisdiction is still insisting on having the fiduciary and misappropriation theories as the bases for the regulation of trading on inside information, it does recognise that in certain situations the operation of an equal access to information-like prohibition is required. The United States courts acknowledge this.[925] Secondly, the rule provides an example of what is required for liability in an equal access regime. Determining whether certain conduct falls foul of the rule involves a series of factual enquiries. As that determination does not include an enquiry as to the trader's, or the tipper's, identity, other parameters are needed to limit liability. The knowledge requirement is especially relevant in that regard.

[925] See *SEC v Mayhew* 121 F 3d 44 (2d Cir 1997) where it was said that: 'Rule 14-e3 imposes liability . . . without regard to whether the trader owes a fiduciary duty to respect the confidentiality of the information'. Also see K A Tallman "Private Causes of Action under SEC Rule 14e-3" (1983) 51 *Geo Wash L Rev* 290 295–296.

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4 3 1 5 Politicians

The South African definition of insider does not expressly include politicians. It does include persons who have access to inside information 'through having access to such information by virtue of . . . office'.[926] The dictionary definition of 'office' includes 'a position of authority or service, typically one of a public nature'.[927] South African politicians are therefore also recognised as insiders by the definition.

A 2004 United States study showed that senators beat securities market indexes by, on average, 12% a year.[928] This statistic is especially interesting if it is viewed against two others: for the same period households underperformed against the market by 12% and traditional corporate insiders beat the market by only 6%. Bainbridge makes the reasonable inference that some senators must have had access to, and were using, inside information about the companies in whose securities they traded.[929] He concludes that it is highly probable that the misuse of inside information by politicians is common.[930] There is no reason to believe that South African politicians conduct themselves differently. To the contrary.

It is of little doubt that politicians have an exploitable advantage when it comes to trading in the securities markets. Manne already recognised this fact near on sixty years ago.[931]

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926 Soanes & Stevenson *Oxford Dictionary of English*.
927 Ibid.
928 A J Ziobrowski, P Cheng, J W Boyd & B J Ziobrowski "Abnormal Returns from the Common Stock Investments of the US Senate" (2004) 39 *J Fin & Quant Analysis* 661.
929 S M Bainbridge "Insider Trading Inside the Beltway" (2010) 36 *J Corp L* 281 282.
930 Bainbridge (2010) *J Corp L* 297 citing Ziobrowski, Cheng, Boyd & Ziobrowski (2004) *J Fin & Quantitative Analysis* 670.
931 H G Manne *Insider Trading and the Stock Market* (1966) 171–179. Manne recognised that the 'federal government is the largest producer of information capable of having a substantial effect on stock-market prices'. (Ibid. 171) Government is not only a producer of valuable securities markets information, it is also the ultimate recipient. Vast amounts of information must be disclosed to government before it is made public. (172) Politicians therefore have access to extremely valuable information. (Ibid. 179)

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Situations in which politicians have access to inside information abound. Among other things, they have access to inside information when corporations disclose information in the confidential setting of congressional or parliamentary hearings and investigations.[932] They also have access to draft white papers on, say, tax legislation yet to be tabled. This enables them to know which companies may face a tougher or a more lenient tax regime in future. They further have information about government contracts and the approval of, say, a new drug, sure to make the developer company's securities' prices rise.[933]

The problem in the United States was that under *Dirks* and *Chiarella*, the classical theory did not prohibit senators from trading on inside information. While *Dirks* recognised that certain types of outsiders, with an especially close relationship to issuing firms, could become constructive insiders, these circumstances could be found only in scenarios where corporate information was legitimately revealed to underwriters, accountants, lawyers, or consultants working for the corporation. Only they could become fiduciaries of the corporation and could therefore be held liable as insiders.[934] Second, *Dirks* recognised that tippees could be held liable only when the tipper, the insider, breaches a fiduciary duty through his disclosure of the information to the tippee, and the tippee knows or has reason to know of the breach.[935] Members of Congress's information, however, did not typically come by the way of a breach of a duty to an issuer or some other firm. In addition, members of Congress and their senior staff are prohibited from serving as officers or senior members of the boards of associations,

[932] Bainbridge (2010) *J Corp L* 286.
[933] Ibid.
[934] *Dirks* 655 footnote 14.
[935] Ibid. 660.

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corporations or other entities.[936] They are therefore unlikely to be categorised as a classical or a constructive insider.[937]

The misappropriation theory was considered to be a bad fit.[938] Under the misappropriation theory, as it was formulated in *O'Hagan*, a person is prohibited from trading only where he owes a duty to the source of the information. His trade must be in breach of that duty.[939] The difficulty is that congressional agents owe different duties to their employer. While congressional aides and other government employees, for instance, have definite fiduciary relationships with their employer and they have duties arising out of their employment contracts, Members of Congress are merely bound by implied obligations created by congressional ethics rules.[940] Typically then, Members of Congress owe no duty to the source of the information in which they trade.

The Stop Trading on Congressional Knowledge Act of 2012 (also referred to as the 'Stock Act') was thus enacted. As the name suggests, the Act is aimed at prohibiting members of Congress from using non-public information derived from their official positions for personal benefit.[941] It enjoins the Select Committee on Ethics of the Senate and the Committee on Ethics of the House of Representatives to issue interpretive guidance to clarify that members and employees of Congress[942] may not use non-public information derived from their positions

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[936] Bainbridge (2010) *J Corp L* 290. He refers to the "Restrictions on Outside Employment To Members and Senior Staff" United States government document. It is available at http://ethics.house.gov/subjects/topics.

[937] Bainbridge (2010) *J Corp L* 290.

[938] Bainbridge (2010) *J Corp L* 293.

[939] Ibid.

[940] Ibid.

[941] See the preamble to the Stock Act.

[942] The Stock Act also touches on the conduct of other federal officials, including judicial officers and employees. Section 9(2) to (3) provides:

> (2) Judicial officers — The Judicial Conference of the United States shall issue such interpretive guidance of the relevant ethics rules applicable to Federal judges, including the code of conduct for United States Judges, as necessary to clarify that no judicial officer may use non-public information derived from such person's position as a judicial officer or gained

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or gained from the performance of their official responsibilities as a means of making a private profit.[943] The Act further expressly states that members and employees of Congress are not exempt from section 10(b) and Rule 10b-5[944] and it addresses various reporting duties.[945] It determines that a duty arises from the relationship of trust and confidence owed by each member and employee of Congress.[946] It amends the Securities and Exchange Act[947] to provide expressly that:

> each member of Congress or employee of Congress owes a duty arising from a relationship of trust and confidence to the Congress, the United States Government, and the citizens of the United States with respect to material, non-public information derived from such person's position as a member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.[948]

> from the performance of such person's official responsibilities as a means for making private profit.
>
> (3) Judicial employees — The Judicial Conference of the United States shall issue such interpretive guidance of the relevant ethics rules applicable to judicial employees as necessary to clarify that no judicial employee may use non-public information derived from such person's position as a judicial employee or gained from the performance of such person's official responsibilities as a means for making a private profit.

943 Section 3 of the Stock Act.
944 Section 4(a) of the Stock Act.
945 See sections 6 to 8 of the Stock Act.
946 Section 4(b)(1) of the Stock Act.
947 The amendment was inserted into section 21 of the Securities and Exchange Act of 1934.
948 Section 4(b)(2) of the Stock Act.

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4 3 2 Tippees

As the South African definition's closed group fails to include all market participants with access to inside information, the legislature has had to create a further main group of insiders: 'tippees'. The recognition of the concept is a consequence of the legislature's failure to find a single basis for the liability of all market participants who deal with inside information. It contributes to the South African insider trading legislation's complexity. In addition, as United States law shows, the search for and determination of a basis for the liability of tippees are not conducive to the development of accessible, coherent and consistent jurisprudence.[949]

4 3 2 1 Knowledge of the source

In the Financial Markets Act, primary insiders are recognised as such with reference to the way 'through' which they have access to inside information. Tippees are recognised as insiders purely because of their knowledge. According to subsection (b) a person who has inside information is an insider of this category if she 'knows that the direct or indirect source of the information was a primary insider.[950]

There are three reasons why this knowledge requirement should not be in the definition of 'insider'. Firstly, it leaves the legislative scheme complex. All the elements of the prohibited conduct section are not contained within one easily accessible section. Two elements that relate to the same subject matter (knowledge) are split over two sections: the definitions section (section 77) and the prohibited conduct section (section 78). The term 'insider', and therefore potentially 'tippee' and its knowledge requirement, is used in four of the five prohibited

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[949] For the proposition that these are the characteristics of 'good jurisprudence' see T Etherton "Contract Formation and the Fog of Rectification" (2015) 68 *Current Leg Prob* 367 385.

[950] Section 77(b) of the Act.

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conduct subsections. Each type of prohibited conduct described in section 78 of the Act, however, already includes a knowledge requirement. 'Persons' who deal for insiders, are required to know that the person that they are dealing for is an insider.[951] All the other types of prohibited conduct use the term insider. An insider who knows that he or she has inside information may not deal in securities to which the inside information relates.[952] An insider who knows that he or she has inside information may not trade for another.[953] The tipping offence requires an insider to know that he or she has inside information.[954] The encouragement and discouragement offence requires an insider to know that he or she has inside information.[955]

Secondly, and more importantly, the knowledge requirement contained in the definition makes knowledge of the information's source a prerequisite to the liability for insider trading of some of the participants in the financial markets. It should not be. Knowledge of the source of information serves only as one of many possible indicators that a trader has knowledge of the fact that the information he possesses is not legally accessible by the public.[956] To make knowledge of the source a prerequisite to liability, is to potentially allow some participants who know that they have inside information to deal with the information, for so long as they do not have knowledge of the direct or indirect source of the information. This means that even if that person has knowledge of the fact that she has inside information she would be free to deal with the information for so long as she does not have knowledge of its source and she is not a primary insider.

[951] Section 78(3) of the Act.
[952] Section 78(1) of the Act.
[953] Section 78(2) of the Act.
[954] Section 78(4) of the Act.
[955] Section 78(5) of the Act.
[956] See above p. 204.

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Thirdly, to include this knowledge requirement in one of the definitions is to make the liability of some of the participants in the financial markets dependent on whether the direct or indirect source of the information is indeed a primary insider. The knowledge requirement in the definition uses the phrase '[t]o know'. '[T]o know' is to 'be aware of through observation', 'to have knowledge or information concerning' or to be 'absolutely certain about'.[957] It is to be compared to 'to believe', which is to 'accept that (something) is true, especially without proof', 'to have confidence in' or to 'hold (something) as an opinion'.[958] 'To know' something, as opposed to 'to believe' something, suggests knowledge of an existing fact. The distinction is important: 'to know' connotes the actual existence of a primary insider who is the source of the tippee's inside information. The tippee's recognition as an insider therefore depends on the actual existence of a primary insider who is the source of the tippee's inside information. This makes one person's liability, the tippee, dependent on the conduct of another, the primary insider.

4 3 2 2 Derivative liability

In the United States tippee liability also depends on the existence of the primary insider and her conduct. Its courts' judgments provide examples of the arbitrary results this type of derivative liability leads to. The cause of these arbitrary results is obvious: a court is made to look to the conduct of one person, the primary insider, to determine the liability of another, the tippee.

In *Dirks*,[959] the Supreme Court of the United States set out the test for tippee liability as follows:

> '[T]he tippee's duty to disclose or abstain is derived from [the] insider's duty . . . [T]he test is whether the insider personally will benefit, directly or indirectly, from his

[957] Soanes & Stevenson *Oxford Dictionary of English*.
[958] Soanes & Stevenson *Oxford Dictionary of English*.
[959] *Dirks* 659–662. See p. 97 et seq. above.

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> disclosure. Absent some personal gain, there has been no breach of duty to stockholders. . . . This requires courts to focus, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or reputational benefit that will translate into future earnings. There are objective facts and circumstances that often justify such inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of non-public information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[960]

Tippee liability was therefore made dependent at least on whether the insider breaches her duty to the holders of securities and whether she gains personally from making the tip. The application of the first mentioned requirement is illustrated by *SEC v Switzer*.[961] Switzer was a football coach at a university in Oklahoma. Platt was the chief executive officer and chairman of the board of Texas International Corporation and a director of Phoenix Resources Company. Phoenix was not doing well and its future was uncertain. For some time, Platt had sought either to split Phoenix from Texas International, to merge the two companies, or to sell Phoenix and liquidate its assets. Throughout the course of a sports day, Platt remained in one place in the stands. Switzer moved around, at times speaking to his son or other participants and their families, watching different events, and signing autographs.[962] He also spoke to Platt on a number of occasions. They talked about their sons' participation in sports, the oil and gas business, the economy in general, football, and their investments. They did not have a conversation about any mergers, acquisitions, takeovers or possible liquidations of Phoenix in which Morgan Stanley would play a part. Platt further did not make any stock recommendations to Switzer, nor did he intentionally communicate inside information to him. The information Switzer gathered was overheard and was not, it was found, the result of an intentional disclosure by Platt.

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960 *Dirks v SEC* 463 US 646 (1983) 662–64 (citations omitted).
961 *SEC v Switzer* 590 F Supp 756 (WD Okla 1984).
962 Ibid. par. 39.

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At one point Switzer was lying behind Platt in the stands. Switzer overheard Platt talking to his wife about his trip to New York the previous day. Platt mentioned Morgan Stanley and its desire to dispose of or liquidate Phoenix. He also heard Platt talking about several companies bidding for Phoenix and that an announcement of a 'possible' liquidation of Phoenix might occur. Switzer remained behind the Platts for twenty minutes.[963] Platt was not aware of Switzer's presence behind him in the stadium, nor that Switzer had overheard anything that he had said.[964]

The court focused on Platt's conduct. It was found that Platt had returned home late the previous day from his meetings in New York. His wife was to leave town for an entire week the following day. As they had minor children, it was their practice to arrange for Platt to be at home when his wife was out of town. The sports day provided the Platts with an opportunity to discuss their respective plans for the upcoming week. The evidence was that during these discussions, Platt mentioned his prior business activities in New York and his resultant obligations and appointments. The court further recorded it was also the practice that when Platt appeared distracted he would talk to his wife about his problems, even though she did not have an understanding nor interest in business matters.[965] On the sports day, Phoenix was weighing on Platt's mind, as it had been for several years, prompting Platt to talk to his wife about it.[966]

Subsequent to overhearing the information, Switzer returned home and looked up the price of Phoenix's securities. Switzer then met with his investing partner, discussed the information he had overheard, and decided to purchase Phoenix stock.[967] It was common cause that Platt

963 Ibid. par. 41.
964 Ibid. par. 43.
965 Ibid. par. 44.
966 Ibid. par. 44.
967 Ibid. par. 46.

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was an insider at Phoenix. Switzer was not an insider of Phoenix, nor did he owe any fiduciary duty to the shareholders of Phoenix.[968]

The court emphasised the fact that the information was given from spouse to spouse and that it was merely one spouse informing the other of his upcoming business schedule in order for arrangements to be made for a child to be cared for.[969] The information was, furthermore, inadvertently overheard.[970] The court accordingly found that Platt did not intentionally give the information to Switzer, nor did Platt make the disclosure for an improper purpose.[971] The court found that as Platt had not breached any fiduciary or other duty to the stockholders of Phoenix when he told his wife of the possible liquidation of the company[972] Switzer was not guilty of insider trading.[973]

Another example of the results consequent upon a requirement of a breach of duty by the source of the information, is found in *R v Fischer*.[974] The defendants in the case were prospective buyers of a controlling block of shares in a company. They traded with inside information, but were not found guilty of insider trading as no duty to the source of the information had been breached. The owners of the controlling block of shares had contacted a merchant banker to find a suitable purchaser for their stakes in the company. Despite the defendants' expression of interest, the owners sold to another purchaser, whom they considered more suitable. The owners instructed the merchant bankers to inform the defendants that the deal was not to proceed. The instruction was carried out. The defendants then bought shares in the target firm before the public announcement of the deal was made in

968 Ibid. par. 67.4.
969 Ibid. par. 44.10.
970 Ibid. par. 44.11.
971 Ibid. par. 44.13.
972 Ibid. par. 44.9.
973 Ibid. par. 44.16.
974 (1988) 4 B.C.C. 360. As discussed by Loke (2006) *Am J Corp L* 141.

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the financial press. As the merchant banker had not breached a duty in the disclosure of the information to the defendants, the defendants were free to trade.[975]

4 3 2 3 Remote tippees

The fact that tippee liability is made dependent upon, or is derived from, the conduct of a primary insider not only gives rise to arbitrary results, it also leads to evidentiary difficulties as the conduct of the primary insider may be far removed from the impugned conduct. Tippees receive their information, according to the South African definition, either 'directly' or 'indirectly' from a primary insider. In other words, the primary insider does not have to be the direct source of the information. The tippee could receive the information from another tippee, who could have received the information from another tippee, and so on. These tippees, that do not receive their inside information from a primary insider, but from another tippee, are 'remote' tippees.

The South African definition requires that also remote tippees have knowledge of the fact that the source of the inside information was a primary insider and, as it has been explained, the source must actually have been a primary insider. This means that, even in situations where the disclosure of the information by the primary insider are far removed from the wrongful trade (a trade with knowledge that the trader is in possession of inside information) the focus remains on the conduct of the primary insider. The United States legal position suffers from the same defect.

[975] Loke (2006) *Am J Corp L* 141.

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In *U.S. v Falcone*[976] the McGraw-Hill company published a weekly article in Business Week magazine. The column evaluated three companies with the intention of giving its readers an insider look at certain securities on Wall Street. The writer of the column gathered information by talking to CEOs, money managers and securities analysts.[977] The article was released on the internet at five o'clock on Thursdays. It was available on newsstands on Fridays. To ensure that these release times were adhered to, Business Week followed stringent security procedures. Evidence was led that at Business Week's headquarters the article was protected by way of limiting the number of people who had access to it before its publication. The names of the relevant securities were not inserted until late the Wednesday before publication. In addition, it was Business Week's policy that no writer, editor or reporter would be permitted to buy or sell stock on subject matter that he had worked on until two weeks after the information had been made public. If an employee regularly reported on a particular stock, the individual was barred indefinitely from purchasing the stock.[978]

After the article was completed, there were various people in possession of the information contained in the article. The article was also sent to a graphics company and then to three printing plants. The graphics company and the printing plants had security procedures in place.[979] After the printing process, the magazine was sent to a national distributor, the Curtis Circulation Company (Curtis). Curtis in turn sold the magazines to various wholesalers. One such wholesaler was Hudson News (Hudson). Curtis distributed policy documents to all its wholesalers, including Hudson, to the effect that the magazines were not to be distributed before five o'clock on Thursdays. Hudson also had its own security and confidentiality procedures in place.[980]

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976 97 F Supp 2d 297 (EDNY 2000). Affirmed on appeal in *U.S. v Falcone* 257 F 3d 226 (2nd Circuit 2001).
977 Ibid. 298.
978 Ibid.
979 Ibid. 299.
980 Ibid.

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All these security measures notwithstanding, the senior editor of Business Week noticed an abnormal trading pattern among the securities mentioned in the column: those securities' prices would rise before the publication of the article. The following scheme was discovered: Gregory Salvage was a foreman at Hudson and had been employed by the company for more than twenty years. There was no question that he was aware of the security policies of Hudson.[981] Nevertheless, out of the prompting of a neighbourhood friend and broker, Larry Smath, Salvage arranged for Smath to receive a copy of the 'Inside Wall Street' article before it was made available to the general public so that he could trade on the stock and make a profit.[982]

To facilitate this, Salvage drew in one of his subordinates on the day shift, Mohammed, and requested him to fax the article to Smath at his workplace, before the close of the market on Thursdays. Salvage was paid two hundred dollars for each article. Salvage paid Mohammed twenty-five dollars for each copy he faxed.[983] In the planning stages of the scheme, Smath also phoned Falcone, the defendant in the case, who was a securities broker. He was told to simply 'write down these symbols' and not to 'ask any other questions'. At some point Smath and Falcone met at the latter's house. Smath then informed Falcone of the intricacies of the scheme concerning the receipt of the information.[984]

Based on this evidence, Falcone was convicted of insider trading.[985] The court, however, raised its concern about the boundless expansion of liability. The court's unease about convicting Falcone lay in the fact that it was highly questionable whether the participants breached a duty to the source of the information. Salvage and Mohammed were after all employees of Hudson and were therefore far removed from the source of the inside

[981] Ibid. 300.
[982] Ibid.
[983] Ibid.
[984] Ibid. 300.
[985] Ibid. 301.

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information. In fact, remarked the court, no less than three intermediaries preceded Hudson's participation in the process in which the information was disseminated.[986]

In *SEC v Musella*[987] the United States District Court of New York was confronted with a factual scenario where a stock market layman was used to purchase securities for his instructors. That layman, Musella, passed inside information on to a broker, DeAngelis. The tipper in the case was Ihne, a manager of the office services department of a New York law firm. Ihne came to know information about proposed and anticipated tender offers, mergers, and leveraged buyouts as a result of his firm giving legal advice in that regard. Ihne admitted to his wrongdoing, was found guilty, and was sentenced accordingly. Ihne, however, was not operating alone. He had shared his information with a friend, Stivaletti, and his stockbroker, Palomba. These three men formed a pact in which Ihne would steal confidential information and pass it on to Stivalleti, who would ultimately make their investment decisions. Palomba would use his account to purchase the securities for the group. Palomba, however, became uncomfortable with the fact that he had to purchase the securities with his own account. Another plan was made. This is where Musella entered the picture. Stivalleti enlisted Musella, the brother of a college classmate, to purchase the securities for the group. The profits would be divided evenly. The securities purchase, which Musella made according to the scheme, was the first of his life. Evidence was led that he had an extremely limited knowledge of the securities markets. He was a beautician by profession and the owner of the Swirl & Curl beauty salon in Brooklyn. He had been given instructions on what to buy and bought accordingly. Musella also relayed the information to a friend, one DeAngelis. He in turn purchased securities based on the information for his own account. DeAngelis could thus properly be described as a remote tippee.

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[986] Ibid. 302.

[987] *SEC v Musella* 748 F Supp 1028 (SDNY 1989). See *Langevoort on insider trading* (Rel 6 4/2008) 4-29.

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Among the issues before the court was whether Musella's lack of being fully informed about the transactions could allow DeAngelis to be acquitted. Was the information chain broken to a sufficient degree to render DeAngelis not guilty of inside information trading? Musella did not know who the original source of the information given to him was. The court emphasised the fact that he did know he was receiving stolen, confidential information. He 'candidly understood' that the information he was receiving was based on material, non-public information.[988] He knew that the information was illegally obtained. He referred to the source as 'the Goose who laid the Golden Egg'.[989] What is more, it was clear that Musella knew that he was busying himself with a wrongful scheme.[990] The court concluded as follows:

> Material, inside information about a pending tender offer is likely to come from the acquiring company or someone acting on its behalf. Thus, even assuming Musella did not know the specific source of the inside information he passed along to DeAngelis, DeAngelis was a sufficiently sophisticated investor to know or have reason to know that the source of Musella's information was either the 'offering person' or someone acting on its behalf. . . .[991]

Traders like Musella and De Angelis, if they are found not to be primary insiders, would not be tippees in South African law.

4 3 2 4 Temporary insiders

The arbitrariness inherent in making one person's liability dependent on that of another, where the wrongfulness of the first mentioned's conduct and the irrelevance of the last mentioned's

988 Ibid. 1035.
989 Ibid. 1038.
990 Ibid. 1035. Evidence was led that Musella, on one occasion, showed Stivaletti a magazine article about insider trading. The article described different sorts of people who could get access to inside information, including lawyers, secretaries and printers. It contained a cartoon depicting various possible sources of illegally obtained confidential information. Musella pointed to the cartoon and asked Stivaletti which one of the people in the cartoon depicted Stivaletti's source. Stivaletti replied: 'it's one of those'.
991 *SEC v Musella* 748 F Supp 1028 (SDNY 1989) 1042.

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conduct is apparent, leads to judicial ingenuity at the cost of legal certainty. In *SEC v Lund*,[992] for instance, the Court was confronted with a situation in which there was clearly no fiduciary duty breached by the information being communicated to Lund, the tippee. The facts were as follows. Lund stood at the helm of a company called Verit Industries. One Horowitz was a member of Verit's board and had been for more than seven years. Horowitz also held the office of chief executive officer, president, as well as chairman of the board in another company, P&F Industries Inc. Prior to the events that led to Lund's indictment, Lund and Horowitz regularly spoke and exchanged information about the two companies.

In the course of 1979 Horowitz, acting on behalf of P&F, entered into negotiations with another corporation with the intention of entering into a joint venture. When it became clear that there was a good chance of the joint venture coming to fruition, Horowitz approached Lund about the prospect of a capital investment into the joint venture. Shortly after Horowitz spoke to Lund, the latter placed an order for a large amount of P&F stock with his stockbroker. The order was executed. The joint venture was approved by P&F board and a letter of intent was signed. On the date of the signature the American Stock Exchange delayed trading until a public announcement about the joint venture could be made. When trading reopened, the trading volume and price of P&F stock rose dramatically and remained high for weeks. Lund sold his stock and realised a substantial profit.

The court acknowledged the fact that it had long been established in United States federal law that tippees could be held liable for trading with inside information. It acknowledged, further, the qualification the United States Supreme Court had placed on tippee liability in *Dirks*, that 'tippee liability cannot be imposed unless the "tipper" has breached a fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.'[993] So, reasoned the court, Lund could not be held liable as a

992 570 F Supp 1397 (CD Cal 1983).
993 Ibid. 1402.

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tippee as Horowitz had not breached a fiduciary duty in communicating the material, non-public information to him. Horowitz's disclosure of the information had been done within his authority as a director of the company. But, surprisingly and incorrectly in light of *Dirks*, the court held that this was not the end of the enquiry. A further question needed to be asked: could Lund be held liable as an insider proper?

To answer this question the court embarked on an analysis of what is to be understood under the term insider. It held that '[a]lthough corporate insiders are traditionally defined as officers, directors and controlling shareholders of the corporation, a consistent body of case law makes clear that the scope of the concept "insider" is flexible.'[994] Therefore, held the court, '[p]ersons who, although not traditional "insiders", nevertheless become fiduciaries of the corporation and the shareholders could be called "temporary insiders."' They, it was said, assume the duties of an insider temporarily, by virtue of a special relationship with the relevant corporation.[995]

The court concluded that Lund was a 'temporary' P&F insider when he traded on the basis of the information concerning the joint venture. It found that the exchange of information between Horowitz and Lund about their corporations took place within the confines of a long-term friendship. What was more, Horowitz had sat on the Board of Verit and Horowitz had told Verit, through Lund, of the joint venture because of this special relationship. It found that 'the information was made available to Lund solely for corporate purposes'. The court further remarked that Lund had known that the information was to be kept confidential and that it was not to be used for 'personal gain'.[996] Under these circumstances, the court found, Lund became a temporary P&F insider on receipt of the information about the gambling project and assumed

[994] Ibid. 1402.
[995] Ibid. 1403.
[996] Ibid.

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an insider's duty to disclose or abstain from trading based on that information, and therefore that Lund's trading on the information was actionable under section 10(b).[997]

4 3 2 5 The personal benefit requirement

As it is clear from the quotation from *Dirks* above,[998] that the United States Supreme Court requires a tipper personally to benefit from making a tip to establish the tippee's liability. The requirement was developed in fear of open-ended tippee liability.[999] The court is concerned about friendly cooperative meetings between corporate officials and outsiders. These types of meetings, it is said, occur all the time and should not be seen as a 'co-venture' that would extend the fiduciary obligation to the outsider.[1000] If that were to be the case, there would be few cases of confidential information flow from within the corporation that would not be covered by the theory.[1001] The court is also concerned about situations in which investment analysts conduct meetings for the purpose of gathering information.[1002] The investment market analysts' essential function of promoting marketplace efficiency by 'ferreting out' issuer-related information is to be protected.[1003]

A propensity to open-ended liability in this context is rather the result of not having a single, clear basis for regulating insider trading. The personal benefit test is a stopgap, superficial solution to that fundamental underlying problem. If it is not absurd in itself, it has given rise to absurd results. In the typical tipping situation, there is no actual pecuniary benefit to an

[997] Ibid.
[998] Above p. 256.
[999] *Langevoort on insder trading* (Rel 6 4/2008) 4-7.
[1000] Ibid.
[1001] Ibid.
[1002] Ibid. 4-7 – 4-8.
[1003] Ibid. 4-8 footnote 3.

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insider.[1004] There is no kickback or expectation that there will be a reciprocal tip sometime in the future. For this reason the United States courts have had to extend the meaning of 'benefit' to situations where the insider is, for instance, seeking to enhance his own reputation or to obtain the 'warm glow' that purportedly comes from giving tips to friends.[1005] This gives rise to a situation wherein the person who comes into contact with the insider is forced to engage in some kind of 'motivational analysis' in respect of the insider under circumstances that defy prediction.[1006]

Three types of personal benefit can satisfy the *Dirks* test: pecuniary benefit, reputational benefit, and the 'Santa Claus' benefit. Pecuniary benefit is taken to include any sense in which the insider tangibly profits from the tippee's insider trading.[1007] This would include kickback and profit-share arrangements, but also trades made by a spouse whose income becomes available to the whole household. A reputational benefit would accrue where an insider provides inside information to another, say an investment analyst, in the hope that the investment analyst may say favourable things about the tipper in the future.[1008] The Santa Claus benefit has been described as follows:

> The most interesting type of personal benefit is that which comes from making a gift. According to the court, tipping just to do something nice for someone else resembles trading by the insider himself followed by a gift of the proceeds to the other person. . . . Here doctrinal consistency has apparently given way to the recognition that the typical tip is neither for pecuniary nor reputational benefit, but is nonetheless a misuse of corporate information by the insider. Thus, the concept of benefit has been expanded to include the satisfaction that comes from playing 'Santa Claus' with inside information.[1009]

[1004] Ibid.
[1005] Ibid.
[1006] Ibid.
[1007] *Langevoort on insider trading* (Rel 6 4/2008) 4-11.
[1008] Ibid. 4-12 – 4-13.
[1009] Ibid. 4-12 – 4-13.

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In *SEC v Downe*[1010] Warde stood accused of trading in the securities of Kidde Inc while in possession of inside information.[1011] Warde was alleged to have received the information from a director of Kidde, Downe. The court heard testimony that Warde and Downe were good friends. They would socialise regularly and each would visit the other at his family home. They played cards and shared interests in art and the stock market. They were also both professional investors. The court *a quo* found Downe had relayed inside information to Warde. As to whether there was personal benefit to Downe, the court wrote:

> With respect to this element, little need be said. A benefit to the tipper can be shown, *inter alia*, by the relationship between the insider and the recipient in which the tip is part of an exchange of benefits, or can constitute the benefit enjoyed by the giver of a gift. . . . Here, Downe testified that Warde had mentioned Golden Nugget and Bank of America to him. While Warde argued that this comment could hardly have been a recommendation from Warde or a quid pro quo exchange, Downe later invested approximately $1.4 million in Golden Nugget securities. Moreover, Downe testified that 'it was ego' that motivated him to invest his friends; and relatives' money without financial compensation. *From this the jury could reasonably infer that Downe enjoyed the benefits of being viewed as a successful investor in the eyes of his peers – including Warde – as well as the gratification of bestowing the 'gift' of his investment expertise.*[1012] (Emphasis added.)

In *SEC v Sargent*[1013] Shepard was a co-owner of a consulting firm. His co-owner, Aldrich, was also the member of a board of directors for Purolator Products Co., a manufacturer of automotive parts. A company called Mark IV Industries Inc offered to purchase all of the outstanding shares of Purolator. Purolator accepted the offer. Shepard and Aldrich's consulting business was run from a single-room office in Shepard's basement. Shepard could at all times hear what Aldrich said on the telephone and would occasionally retrieve voice mail messages and faxes for Aldrich. After Mark IV had made its offer for Purolator, Aldrich took Shepard into his confidence and advised him that Purolator was being pursued.[1014] Aldrich

[1010] 969 F Supp 149 (SDNY 1997).
[1011] Ibid. 151.
[1012] Ibid. 156.
[1013] 229 F 3d 68 (1st Cir 2000).
[1014] Ibid. 71.

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told Shepard that this fact needed to be kept confidential, and Shepard agreed not to disclose the information.

Less than a month before Purolator accepted Mark IV Inc's offer, Shepard, Sargent, and their wives met for dinner. The reason for their meeting for dinner, so found the court, was to smooth out some problems that had developed between them.[1015] During dinner, Shepard informed Sargent that Purolator was to be bought.[1016] In the following weeks Sargent bought 20 400 Purolator shares.

One of the questions the court had to answer was whether Shepard benefited from the tip to Sargent. The court found that sufficient evidence had been presented to found his benefit. The relevant facts were that Shepard and Sargent were 'friendly',[1017] Shepard tipped Sargent about Purolator in an 'effort to effect a reconciliation with his friend and to maintain a useful networking contract', Shepard had referred over 75 people to Sargent's dental practice, Shepard often went to Sargent for help in connection with Shepard's service to the local chamber of commerce; Shepard's sister-in-law owed Sargent money; and one of Shepard's relatives was threatening to harm Sargent's business.[1018]

[1015] Ibid. 72.
[1016] Ibid.
[1017] Ibid. 77.
[1018] Ibid. 77.

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4 3 3 A critique

To summarise, primary insiders include directors and managers, shareholders, employees, professionals and politicians. In the category 'directors', it includes directors and managers. It also includes executive and independent non-executive directors, not only of issuers but also directors of companies whose position would allow them to have access to inside information. It also includes not only incumbent, but also former directors. In the category 'shareholders', the definition includes current and former shareholders, and minority and majority shareholders. In the category 'employees' the definition includes incumbent and former employees, persons who work under contracts of service and who are contracted to produce a specified piece of work, and issuers as well as other companies' employees who learn inside information through having access to the information by virtue of their employment. In the category 'professionals', the definition includes people with occupations in law, medicine (and its related fields), engineering, the clergy, teaching, architecture, actuarial services, librarianship, social work, journalism, accounting, stockbroking and other financial market professionals. In the category 'politicians', the legislature includes those politicians who hold public office and who have access to inside information through that office. 'Tippees' includes anyone who has inside information and who has knowledge of the fact that the direct or indirect source of the information is a primary insider. It also includes remote tippees.

The arguments as to whether any of these persons or entities should be allowed to trade on inside information are in the final analysis to be viewed against the relevant legislative objectives underlying the Financial Markets Act. As it has been said, the Act aims to ensure that the financial markets are fair, efficient and transparent and to increase confidence in the South African financial markets.[1019] Importantly, the legislature's focus is on the financial markets, not on the divide between ownership and control or the efficiency of the market for management. Arguments that insider trading profits present an efficient form of executive and

[1019] See p. 26 above.

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majority shareholder compensation, emphasise the positive effects of the compensation on matters outside the financial markets, whether they be the health of the market for management or a solution to the separation between ownership and control in firms. These arguments lose sight of the rights and obligations in the financial markets and fairness between the parties in those markets.

The arguments that do relate to the operation of the financial markets, are equally incompatible with the legislature's objectives. To argue, for instance, that directors and managers (as opposed to market professionals) must be allowed to trade on inside information as it would enable the production of low cost market information, is irreconcilable with the fact that 'confidence' in the financial markets depends heavily on notions such as the public's belief or faith in the fact that those markets are fair. What member of the public would believe the markets to be fair if only some participants are prohibited from trading with information others do not have access to (while some others are allowed to earn insider trading profits) for the greater good? Surely if there are burdens to be borne for the greater good, they must be borne equally. The legislature cannot be faulted for any of its inclusions into the primary insider category.

The tippee category, on the other hand, whereas it also represents an attempt at inclusivity, is entirely misconceived as it makes knowledge of the source a prerequisite to liability. To do so is to allow some participants who know that they have inside information to deal with the inside information, for so long as they do not have knowledge of the direct or indirect source of the information. This means that even if a person has knowledge of the fact that she has inside information, she would be free to deal with the information for so long as she does not have knowledge of its source and she is not a primary insider. Apart from the possibility that, as a result of the comprehensive nature of the list of primary insiders and the broad language

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used by the legislature in that regard,[1020] the definition of insider does not fail to cover any persons with inside information, this is a flaw in the definition.

The definition also suffers from more fundamental defects. The South African legislature's closed group approach is inappropriate for the regulation of a financial market wrong. The closed group approach is based in the fiduciary doctrine and misappropriation theory which, as it has been explained in chapter 2 of this work,[1021] are not appropriate for the regulation of insider trading in South Africa. The definition of 'insider' presents a key point in the legislative regime where the legislature must establish the equal access theory of regulation. If there is to be a definition of insider in the legislative regime,[1022] it must simply recognise that an insider is a person with inside information.

The distinction drawn by the legislature between the different traders is in any event irrational. To be rational, it would have had to be rationally connected to the objects sought to be achieved by the Financial Markets Act.[1023] Instead, the distinction is based on the fiduciary duty doctrine and the misappropriation theory, theories employed with the objective of respectively addressing the divide between ownership and control and protecting property rights in information. The definition mirrors the United States paradigm that distinguishes among fiduciaries, missapropriators, and tippees. The distinction did not develop with the objective of ensuring that the financial markets are fair, efficient and transparent, and to increase confidence in them; it developed as a result of the fact that the founding basis of insider trading is a makeshift one: the fiduciary doctrine.[1024] It is nothing but an historic relic in the financial

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[1020] This argument is dealt with at p. 330.
[1021] See above p. 27 et seq.
[1022] For the argument that there should not be such a definition in the legislative regime, see p. 325 et seq. below.
[1023] *Ronald Bobroff & Partners Inc v De La Guerre* 2014 (3) SA 134 (CC) par. 7; *Albutt Centre for the Study of Violence and Reconciliation and Others* 2010 (3) SA 293 (CC) par. 51; *Democratic Alliance v President of South Africa and Others* 2013 (1) SA 248 (CC) par. 32.
[1024] See p. 128 above.

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markets, unable to explain the wrongfulness of the conduct of all traders trading with inside information in a market setting.[1025] The further 'development' that occurred in United States law, had very little to do with objectives such as those intended with the Financial Markets Act, and was rather focused on providing hotchpotch solutions to the fiduciary doctrine's failures to explain a financial market wrong. Missapropriators had to capture insiders who did not fit the idea of a traditional fiduciary insider[1026] and tippees provided the overall stopgap. There is no reason why this distinction must be maintained in the South African Financial Markets Act.

[1025] See p. 55 above.
[1026] See p. 66 above.

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4 4 Corporations

The Financial Markets Act does not expressly provide that companies are capable of being insiders. It does so by implication. The lead-in phrase of the definition of insider provides that an 'insider' is a 'person' who has inside information.[1027] A 'person' is defined as including 'a partnership and any trust'.[1028] If this is read with the definition of 'person' in the Interpretation Act[1029] an insider may also be a juristic person.[1030]

This interpretation is reconcilable with the rest of the definition of insider and the three types of insider for which it provides.[1031] The enquiry into the legislature's intention behind the definition is, however, slightly bedevilled by the words used in the prohibited conduct section. Four of the five subsections (that contain the dealing for oneself, the dealing for another, the tipping, and the encouraging or discouraging offences) refer to an insider as 'he' or 'she', not pronouns normally associated with corporations. Subsection 78(3) (that contains the dealing for an insider offence), does not use those pronouns to refer to the perpetrator. It does, however, contain the pronoun 'who'. 'He', 'she' and 'who' are of course not entirely incapable of referring to things other than natural persons. 'She' is, for instance, commonly used to refer to ships. The use of these terms in the prohibited conduct section, when viewed in the context of the Financial Markets Act and particularly its objects, must not affect the fact that 'insiders' may also be juristic persons.

[1027] Section 77 of the Act.
[1028] Ibid.
[1029] Section 2 of the Interpretation Act 33 of 1957.
[1030] R Cassim "Some Aspects of Insider Trading – Has the Securities Act 36 of 2004 Gone too Far?" (2007) 19 *SA Merc LJ* 44.
[1031] Section 77 of the Act.

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It is in any event not novel for South African legislation to consider juristic persons as insiders for the purposes of insider trading provisions. Section 440F of the 1973 Companies Act[1032] also did so. So did the Securities Services Act[1033] which, it can be said, merely effected a return to the position prior to the Insider Trading Act.[1034]

The substantive question whether companies should be recognised as insiders, is slightly more complicated. Firstly, a company can trade wearing more than one hat. Secondly, companies are inherently different in character from natural persons. As to the first complicating factor, a company can trade as an issuer making an initial public offering of its own shares; as a 'repurchaser' of its own shares; or as a trader like any other.[1035] As to the second complicating factor, a company can be large with many different divisions. What may be common knowledge in one division, may be completely unknown in another. If the trading in shares is conducted by the latter division, should the company be held liable as an insider trader?

4 4 1 Issuers

Issuers cannot misappropriate their own information, nor can they owe a fiduciary duty to themselves. That notwithstanding, they are constantly repositories of a wealth of non-public information that, if it were to be made public, would materially affect the trading price on the secondary market for their securities.[1036] Issuers, as opposed to normal market participants, have the resources and the knowledge to engage in at least a great deal of repurchasing activity based on inside information.[1037] The New Zealand Law Commission has gone as far as to call

[1032] Companies Act 61 of 1973.
[1033] Securities Services Act 36 of 2004.
[1034] Insider Trading Act 135 of 1998.
[1035] Loewenstein & Wang (2005) *Del J Corp L* 74.
[1036] S J Choi & E L Talley "Playing Favourites with Shareholders" (2002) 75 *S Cal Rev* 271 307.
[1037] M J Loewenstein & W K S Wang "The Corporation as Insider Trader" (2005) 30 *Del J Corp L* 74.

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a company purchasing its own shares the 'ultimate insider'.[1038] Should companies buying their own shares be seen as insiders at all? If so, should there be exceptions to their liability?

Loewenstein and Wang submit that some of the traditional rationales against insider trading do not apply, or apply with less force, to 'issuer insider buying'.[1039] They argue, firstly, that equitable principles may be one basis for prohibiting a corporation from purchasing its own shares while in possession of inside information. A corporation purchasing its own shares while having inside information goes against 'the fundamental principle which good morals exact, that men should act in honesty and fairness'.[1040] A corporation, say the authors, should act in 'honesty and fairness' when repurchasing its own shares, and disclose material information to the selling shareholder.[1041] The countervailing arguments are that the corporation buying its own shares using inside information would be acting in the best interests of the non-selling shareholders. They might prefer that no disclosure be made.[1042]

The authors then look at the economic effects of issuers repurchasing shares with inside information.[1043] When a corporation trades on inside information, it and its non-selling shareholders, gain an immediate benefit. However, there is simultaneous harm to the selling shareholders. This harm done to the selling shareholders is said to be equal to the benefit that accrues to the company and the non-selling shareholders.[1044] But, imply the authors, it may be deceptive to view this proposition in isolation. Investors are risk averse. The possibility of being a victim of a corporation when it uses inside information to repurchase shares may, in

[1038] See the New Zealand Law Commission, *Company Law Reform and Restatement* (June 1989) ("*New Zealand Law Commission Report*") 100.
[1039] Lowenstein & Wang (2005) *Del J Corp L* 75 72.
[1040] Ibid. 73.
[1041] Ibid.
[1042] Ibid.
[1043] Ibid. 74.
[1044] Ibid.

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the prospective investors' minds, 'override' the possibility of indirectly gaining as a non-selling shareholder.[1045]

Furthermore, they reason, 'outside shareholders' may not have an equal chance of benefiting indirectly from the inside information repurchase.[1046] Corporate managers and large shareholders, perhaps institutional shareholders, could have access to the same information as the company. These managers and large shareholders might not be selling their shares when the corporation places its order, as they would know the inside information on which the order is based.[1047] They would know that it would be in their favour to retain their shares. So, they argue, corporate management and large shareholders could possibly benefit disproportionately when the issuer is repurchasing its shares with inside information.[1048] They further point out that corporate boards, when authorising share repurchases on the basis of undisclosed information, act in the best interests of long-term shareholders, rather than of short-term shareholders.[1049] The preference for the interests of long-term shareholders, if applied to inside information repurchases, would support board policies for the repurchasing of shares based on inside information.[1050]

None of the South African authorities on share repurchases deals, in any material way, with whether corporations should be recognised as insiders.[1051] Cassim merely touches on the

[1045] Ibid. 75.
[1046] Ibid.
[1047] Ibid.
[1048] Ibid.
[1049] Ibid. 76.
[1050] Ibid.
[1051] D Butler "`n Maatskappy se nuwe statutêre bevoegdheid om sy eie aandele te verkry: `n Vertrekpunt" (1999) 10 *Stell LR* 284 290; R Jooste "Issues relating to the regulation of distributions by the 2008 Companies Act" (2009) 126 *SALJ* 627; H E Wainer "The New Companies Act: Peculiarities and Anomolies" (2009) 126 *SALJ* 806; K van der Linde "The solvency and liquidity approach in the Companies Act 2008" (2009) 3 *TSAR* 224; K van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" (2009) 3 *TSAR* 484; K van der Linde "Share repurchases and the protection of shareholders" (2010) 2 *TSAR* 288.

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subject.[1052] The author wrote in 1999, prior to the amendment of the Insider Trading Act,[1053] that corporations are to be included in the definition of 'insider'. According to Cassim, it is important that companies be restricted from repurchasing their shares from shareholders at a time when they have inside information, whether or not the shares are listed.[1054] Cassim does not provide any principle-based reasons for why this must be so.

There are also academics in the United States who submit that an issuer should be held liable for insider trading.[1055] They argued that, when a corporation buys back shares from certain shareholders, what it is doing in effect is taking away the opportunity to realise return from the selling shareholders and reallocating it to the non-selling shareholders.[1056] This favouring of some of the shareholders over others is said to be inconsistent with the basic principles of corporate governance. The argument holds, but it does not explain why a company should also be held liable as an insider under the terms of a prohibition on insider trading.

It will be remembered that in *Dirks*[1057] the United States Supreme Court wrote that insiders are forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage.[1058] The prohibition lies against the insider personally benefiting, directly or indirectly, from his disclosure. Absent some personal gain, said the court, there has been no breach of duty that would found liability.[1059] Although *Dirks* dealt with the extent to which persons, standing outside the corporation, could be held liable, the reasoning was thought to be an indication of a principle to the effect that no insider trading

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[1052] F H I Cassim "The New Statutory Provisions on Company Share Repurchases: A Critical Analysis" (1999) 116 *SALJ* 760 777.
[1053] Act 135 of 1998.
[1054] Cassim (1999) *SALJ* 777.
[1055] *Langevoort on insider trading* (Rel 7 4/2009) 3-8.
[1056] Ibid. 3-8.
[1057] *Dirks v SEC* 463 US 646 (1983).
[1058] Ibid. 659.
[1059] Ibid. 664.

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offence could be committed as long as information is used for a corporate purpose.[1060] It follows that corporations cannot be held liable for insider trading as it is per se impossible for them to act for personal benefit. This seems to have been the line of reasoning followed in some United States cases where it was held that a corporation could not be held liable for insider trading.[1061]

In *American General Ins. Co. v Equitable General Corp*[1062] it was held that an insider's duty to disclose, the non-performance of which leads to his being banned from trading, arises only when he is purchasing shares for his own account and not when he is making purchases for the corporation.[1063] In *Jordan v Global Natural Resources Inc*[1064] the District Court of Ohio held that when a corporation repurchases shares from its shareholders, the erstwhile shareholders' cause of action would lie against the company's officers and directors who authorised the repurchase, but not against the company itself.[1065] The court's reasoning is based on the fiduciary duty doctrine. It held that no fiduciary duty falls on a corporation, as opposed to its officers, in favour of its shareholders.[1066]

The United States courts have also held companies liable as insiders in numerous cases.[1067] In *Castellano v Young & Rubicam Inc*,[1068] Castellano had a long-standing relationship with Young & Rubicam Inc (Y&R). He was employed by the company for many years, culminating in his appointment as chief executive officer of its branch in Italy. The relationship soured as a result of a criminal investigation into allegations that Castellano was involved in bribery to

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1060 *Langevoort on insider trading* (Rel 7 4/2009) 3-8.
1061 *Dirks v SEC* 463 US 646 (1983) 3-9 note 3.
1062 *American General Ins Co v Equitable General Corp* 493 F Supp 721 (ED Va 1980).
1063 Ibid. 743–744.
1064 *Jordan v Global Natural Resources Inc* 564 F Supp 59 (SD Ohio 1983).
1065 Ibid. 67–68. The court did, however, remark that a corporation could be 'held vicariously liable' for the acts of its officers and agents acting within the scope of their actual or apparent authority under the doctrine of *respondeat superior*.
1066 *Jordan v Global Natural Resources Inc* 564 F Supp 59 (SD Ohio 1983) 68.
1067 *Langevoort on insider trading* (Rel 7 4/2009) 3-9.
1068 *Castellano v. Young & Rubicam Inc* 257 F 3d 171 (2nd Circuit 2001).

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secure more business for the company. Although an internal investigation into Castellano's conduct came to naught, the company persuaded him to resign.

At the time of his resignation he was one of the largest shareholders in Y&R. A shareholders' agreement provided for a right of pre-emption in favour of the existent shareholders. Negotiations for the purchase of Castellano's shares were undertaken. Unbeknown to him, Y&R had begun merger negotiations and was planning a restructure that included a listed company. This would potentially effect a substantial increase in Y&R's share price. Castellano sued Y&R, asserting that his decision to resign as a result of the negotiations cost him $7 million. The court held that it

> logically follows that just as knowledgeable corporate insiders have a fiduciary duty to disclose material facts when entering stock deals with outsiders, so do closed corporations buying their own stock.[1069]

McCormick v Fund American Companies Inc[1070] also presents the scenario of a corporate executive resigning and selling his shares. The court held that the corporate issuer in possession of inside information, 'like other insiders in the same situation', should disclose the information to its shareholders or refrain from trading with them. In *Jordan v Duff & Phelps, Inc*[1071] it was held that 'close corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts.' In *Smith v Duff & Phelps*[1072] it was held that the company bears a duty to disclose merger negotiations to an employee who departs voluntarily and sells his shares as a condition of termination. In *Kohler v Kohler*,[1073] after setting out the underlying principles of the insider

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[1069] Ibid. 179.
[1070] *McCormick v Fund American Companies* 26 F 3d 869 (9th Circuit 1994).
[1071] *Jordan v Duff & Phelps Inc* 815 F 2d 429 (7th Circuit 1987) 435.
[1072] *Smith v Duff & Phelps Inc* 891 F 2d 1567 (11th Circuit 1990) 1572–1575.
[1073] *Kohler v Kohler Co.* 319 F 2 d 634 (7th Circuit 1963) 638.

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trading provisions in the Securities and Exchange Act,[1074] the United States Court of Appeals for the Seventh Circuit held that the

> underlying principles apply not only to majority stockholders of corporations and corporate insiders, but equally to corporations themselves when acting through their directors or agents.

In *Green v Hamilton Internat'l*[1075] the court dealt with what it termed an 'interesting issue': whether the redemption of convertible debentures could amount to insider trading. Green owned convertible debentures in Hamilton. The debentures provided that, at any stage before a specified time, the debentures could be converted into Hamilton common stock at $2.75 a share. In the two weeks before the redemption date, Hamilton's common stock was trading well below the conversion rate. Green alleged that Hamilton was aware of the fact that he had intended to redeem the debentures rather than to convert them.

On the day that Green redeemed his debentures, another company made a written proposal to Hamilton to acquire it by purchasing all of its outstanding shares for $4.00 a share. This offer was made public a few days later. At this time Green and his fellow plaintiffs had already lost the opportunity to participate in the merger and to receive the merger price. They demanded rescission of the redemption transaction, but to no avail. They instituted action and alleged, inter alia, that as Hamilton was an insider, there was a duty on it to disclose the material information about the merger transaction.

The court found that the question was whether the timing of the merger transaction was deliberately orchestrated in order to deprive Green and his fellow debenture holders of material information.[1076] This, in turn, led to the question whether Hamilton, as an alleged insider,

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[1074] The court set out these underlying principles by quoting Leahy J in *Speed v Transamerica Corp* 99 F Supp 808 (D.C. Del. 1951) 828–829.

[1075] *Green v Hamilton Internat'l Corp* 437 F Supp 723 (SDNY 1977) 728.

[1076] Ibid. 729.

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owed a duty to disclose.[1077] The court, in referring to, among other authorities, *Kohler* held that:

> there can be no doubt that the prohibition against insider trading extends to a corporation. It was said early of the [Securities and Exchange Act] philosophy that it applies not only to majority stockholders of corporations and corporate insiders, but equally to corporations themselves when acting through their officers, directors and agents.

And, interestingly, that 'by redeeming its own debentures, [Hamilton] "traded" in its own securities'.[1078]

In *Rogen v Ilikon Corp*[1079] *Kohler* was again followed in as far as it held that a corporation is an insider when it buys back its own shares. The judgment bears out the frustration on the part of corporations encumbered by insider trading regulations in trying to repurchase their own stock. Ilikon was a corporation doing business research and development in engineering and science. Rogen was a key individual in the company: he was its president, secretary, and its largest shareholder. He had also conceived of an idea of developing products of aluminium by blowing gas under pressure through a nozzle submerged in molten aluminium. He developed the general concept and supervised its development into a marketable product.

Rogen's colleagues had, however, become dissatisfied with his performance for various reasons. Among them counted his extended absenteeism, a continuing shortening of his workday, an embarrassing consultation with a client, and a disproportionate ownership of shares. He was consequently removed as president and secretary and his employment was terminated. He remained a director. Three months after he had been dismissed as president and secretary, he agreed to sell his shares in Ilikon. It is in those three months that he alleged certain facts material to the sale of his shares had not been disclosed to him. His submissions could be summarised under three heads: that there was a nondisclosure of the revival of certain

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[1077] Ibid.
[1078] Ibid. 729–730.
[1079] 361 F 2d 260 (1st Cir 1966).

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negotiations for the marketing of the product, which Rogen had initiated; that there was nondisclosure of the continuing technological progress made on the project; and thirdly, related to his charges in relation to insider trading, that Ilikon and his former colleagues had made false representations to him about the market for Ilikon shares, which led to a lowering of his asking price for the shares.

The court found that there was enough reason for it to reverse the judgment of the trial court granting summary judgment, and remanded the action for further proceedings. In the conduct of the appeal, the defendants made an argument evidencing the logical frustration on the part of corporations who may feel that they are unjustifiably restrained by the law in repurchasing their own shares. The court wrote as follows:

> Defendants have a reasonable query: what is a company to do in circumstances such as these when delicate preliminary but serious negotiations are being conducted at a time when it is desirable to try to buy out a disaffected stockholder? The options seem to us to be: (1) to refuse to disclose and refrain from buying during negotiations; (2) to disclose and attempt to buy during negotiations; and (3) if it clearly appears that the selling stockholder is in no way relying on non-disclosure, to take a chance on litigation… If these options seem inadequate, the basic answer is that the law has deliberately tried to equalize bargaining power between the individual and the corporation. The fact that during the critical negotiations the scales may be weighted in favour of the departing stockholder is part of the price paid.[1080]

These frustrations, especially when viewed outside the context of the equal access to information theory, are not baseless. If a share buy-back is aimed at promoting, say, consolidation with a view to entering into new expectedly profitable endeavours, would the buy-back not per se be based on inside information? In other words, if a company were to plan certain steps in order to render it more profitable, would it not per se be guilty of trading with inside information, if it does not disclose its intended future course of conduct before

[1080] Ibid. 268.

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performing the buy-back? For the company knows, or at least expects, that it will be more profitable in future as it makes the buy-back.

As a result of these difficulties, the European Union has since 2014 recognised that trading in securities or associated instruments for the stabilisation of securities' prices, or trading in some shares in buy-back programmes, can be legitimate for economic reasons. It was decided that these trades should in certain specified circumstances be exempt from the prohibitions against insider trading.[1081] The application of the exemption is made conditional upon whether the actions are carried out transparently and the relevant information about the stabilisation or buy-back programme is disclosed.[1082] The European Union further recognises that a corporation trading in its own shares in buy-back programmes or to stabilise a financial instrument, which would not benefit from the exemptions under its regulatory scheme, should not of itself be deemed to constitute market abuse.[1083]

A further matter pertinent to issuers being held liable for insider trading, is how other legal requirements of disclosure of information applicable to listed companies correlate with the insider trading prohibitions. For example, firstly, the South African Companies Act determines that an initial public offering can be made only if it is accompanied by a registered prospectus.[1084] The prospectus must contain all the information that an investor may reasonably require to assess the securities being offered, and the assets and liabilities, financial position, profits and losses, cash flow and prospects of the relevant company.[1085] Secondly, the Financial Markets Act provides that an exchange may require an issuer of listed securities

[1081] Par. 11 of the Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (2014 European Regulation).
[1082] Par. 11 of the Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (2014 European Regulation).
[1083] Par. 12 of the preamble to the 2014 European Regulation.
[1084] Section 99(2) of the Companies Act.
[1085] Section 100(2) of the Companies Act.

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to disclose to the exchange any information at the issuer's disposal about the securities, or about the affairs of the issuer, if the disclosure is necessary to achieve one or more of the objects of the Financial Markets Act.[1086] An exchange may also require the issuer to disclose that information to the registered holders of the securities.[1087] When an issuer discloses information to the registered holders of securities that may influence the price of the securities, the issuer must make the information available to the public.[1088]

At least part of the rationale behind these types of disclosures is that they are a means to curb trading on inside information.[1089] It is believed, logically so, that there is a close relationship between the extent of trading on inside information in a market and the timely disclosure of material information by listed companies selling their securities in that market.[1090] There are more opportunities for insider trading if companies fail to disclose material information to the market in a timely fashion. It is accepted that trading on inside information could, at least in part, be prevented by requiring public issuers to continuously disclose inside information. The requirements lessen the opportunities of those in the know to benefit from their information advantage.[1091] Would a company still fall foul of the insider trading provisions on the satisfaction of the disclosure requirements of these Acts? The answer must be that each set of legislative provisions must be complied with in its own right.

[1086] Section 14(1)(a) of the Financial Markets Act.
[1087] Section 14(1)(b) of the Financial Markets Act.
[1088] Section 14(2) of the Financial Markets Act.
[1089] *New Zealand Law Commission Report* 8.
[1090] Ibid.
[1091] Ibid. 9.

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4 4 2 Institutional investors

There has also been debates about whether institutional investors, whether they be insurance companies, commercial banks, mutual funds, hedge funds, endowment funds or pension funds, should not be allowed to trade on inside information. Along the same lines as the argument that insider trading profits are due compensation to controlling shareholders for monitoring management, it is argued that insider trading acts as an incentive for institutional investors to undertake this monitoring function.[1092] In other words, the profits that insider trading gives rise to are justified compensation for the monitoring function that institutional investors undertake.[1093] Accepting that the monitoring of management by institutional investors would be beneficial to the economy and that there is a lack of incentives, and indeed some disincentives, to engage in performing these services, it has been proposed that institutional investors must be allowed to conclude a monitoring agreement with the firm. According to this agreement, they would have the obligation to actively monitor the firm while being entitled to trade on inside information relating to the firm.[1094]

There are certain factors that work against institutional investors fulfilling the monitoring function. When they perform the function, they incur all the costs of monitoring without

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[1092] S Thurber "The Insider Trading Compensation Contract as Inducement to Monitoring by the Institutional Investor" (1994) 1 *Geo Mason L Rev* 119 119.

[1093] Thurber (1994) *Geo Mason L Rev* 119. At that time the author specifically pushed for further supervisory duties for the institutional investors as it was thought that the market for corporate control did not sufficiently provide this service (see specifically at 124). For a discussion of the role played, and to be played by institutional investors in the companies in which they invest, see R J Gilson & R Kraakman "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 *Stanford L Rev* 863. For articles dealing with the market for corporate control as a corporate governance tool see J C Coffee "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in the Market for Corporate Governance" (1984) 84 *Colum L Rev* 1145; M C Jensen & R S Ruback "The Market for Corporate Control" (1983) 11 *J Fin Econ* 5; F H Easterbrook & D R Fischel "Corporate Control Transactions" (1982) 91 *Yale LJ* 698; H G Manne "Our Two Corporations Systems: Law and Economics" (1967) 53 *Va L Rev* 259; H G Manne "Mergers and the Market for Corporate Control" (1965) 73 *J Pol Econ* 110.

[1094] Thurber (1994) *Geo Mason L Rev* 119.

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receiving all the benefit.[1095] All other shareholders of a company will also benefit from the institutional investors' monitoring endeavours, without doing any monitoring themselves. This is known as the collective action problem.[1096] It gives rise to an incentive for other shareholders not to monitor the corporation and its management, but rather to wait and take a free ride on the benefits of another's efforts. The collective action problem discourages the rational shareholder from monitoring management and gives rise to what one author calls 'rational apathy'.[1097]

Institutional investors also hold a large market share and often operate under the assumption that they dominate the market and that they primarily deal only amongst each other.[1098] This is said to result in a belief that the market cannot be beaten and in the setting up of portfolios to reflect the market.[1099] Accordingly, many small equity positions are taken, lessening the incentive to monitor as the cost of monitoring each small investment and how the relevant company is managed, is not justified by the possible benefit it presents. In addition, institutional investor's investments are highly research driven. A security is held only for the amount of time that the market research predicts it is profitable to do so.[1100] When an institutional investor employs this method of investing, a specific security is never held long enough to justify the cost of doing intense monitoring in a specific firm.[1101]

These disincentives to monitoring, it is argued, could be offset by the profits that trading on inside information provides. The profits act as a catalyst for institutional investors to perform

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[1095] Ibid. 125.
[1096] Ibid. Also see E B Rock "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 *Geo L J* 445.
[1097] Ibid.
[1098] Ibid. 126.
[1099] Ibid. 126.
[1100] Ibid. 127. Also see B S Black "Agents Watching Agents: the Promise of Institutional Investor Voice" (1992) 39 *UCLA L Rev* 811 881 and J C Coffee "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 *Colum L Rev* 1277 1288.
[1101] Thurber (1994) *Geo Mason L Rev* 127.

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a more active monitoring role in the economy.[1102] The institutional investor is rewarded for playing a more active role in the firm, in which it monitors the firm's performance, and takes part in formulating and implementing plans to improve it. If these plans are successful, the firm's value increases and so does the investor's investment's value.[1103]

4 4 3 Underwriters

The floatation of shares or the issuance of bonds could either be underwritten by a natural person or a corporation. The Companies Act recognises as much.[1104] It is uncontentious to say that underwriters will normally be companies (mostly investment banks) or, indeed, a group of companies. Interesting questions arise about underwriters' activities and, specifically, which of their activities could be recognised as insider trading.

The first important distinction is the conclusion of the underwriting agreement (which is not a trade on a stock exchange) and the actual marketing of securities, which came to the fore in *Hooker Investments Pty Ltd v Baring Brothers Halkerston & Partners Securities Ltd*.[1105] Inside information about a company called Email was shared with Barings Brothers to procure the latter's services as an underwriter. Barings Brothers shared the information with other parties and entities in an effort to market the shares and to procure sub-underwriters. One of these entities, Hooker, sought a restraining order against Barings Brothers, and against the other defendants, to stop them from contravening the insider trading provisions of the old

[1102] Ibid. 129.
[1103] Ibid.
[1104] Section 100(7) of the Companies Act.
[1105] (1986) 10 ACLR 462, and on appeal *Hooker Investments Pty Ltd v Baring Bros Halkerston & Partners Securities Ltd* (No 2) (1986) 5 NSWLR 157. For further discussions of this case see A Black "The Reform of Insider Trading Law in Australia" (1992) 15 *UNSWLJ* 214.

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Australian insider trading regime.[1106] Hooker had to show that the three underwriters were persons connected to the issuer.

The first issue the court had to address was whether the legislation struck bodies corporate. It was faced with a definition of 'person' that included a 'body politic or corporate as well as a natural person'.[1107] The court reasoned that it was only a very specific type of person who was prohibited from dealing in securities with inside information: one 'who is or has been connected with a body corporate.'[1108] It held these words to provide an exhaustive statement of the circumstances in which persons could be connected to a body corporate. And, as is evident from the court's reasoning, 'who' connoted only natural persons.[1109]

In respect of the sharing of inside information with Barings Bothers, the court distinguished between the conclusion of the underwriting agreement and the subsequent sale of the shares. It held as follows:

> It was then argued that section 128(1) precluded not only the entering into of an underwriting agreement in respect of the shares but also any subsequent sale of the issue shares on the market. However, the "dealing" which is a question in the present case is the underwriting of the shares. An offence is committed . . . only if a person underwriting the shares was in possession of information that was likely materially to affect the price of that proposed issue and the underwriting of the proposed issue was

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[1106] The relevant provisions as they are found in the Securities Industry (New South Wales) Code are as follows. Section 128(1) read:

> A person who is, or at any time in the preceding 6 months has been, connected with a body corporate shall not deal in any securities of that body corporate if by reason of his so being, or having been, connected with that body corporate he is in possession of information that is not generally available but, if it were, would be likely materially to affect the price of those securities.

Section 4 explicitly defines 'dealing' as including 'acquiring, disposing of, subscribing for or underwriting the securities, or making or offering to make, or inducing or attempting to induce a person to make an offer or offer to make, an agreement—(a) for or with respect to acquiring, disposing of, subscribing for or underwriting the securities'.

[1107] *Hooker Investments Pty Ltd v Baring Bros Halkerston & Partners Securities Ltd* (No 2) (1986) 5 NSWLR 157 161B.

[1108] Ibid. 161C.

[1109] Ibid. 161C–162D.

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> prohibited . . . . [The section] only precludes the body corporate from "dealing in those securities" which the officer of that body corporate is precluded from dealing in.[1110]

The court held further that:[1111]

> Accordingly, it seems to me that one approaches section 128 with the idea that it is directed to people who are trading in the market place and are involving themselves in a transaction where a price could be affected by information and the purpose of the Act is to prevent one person having an unfair advantage over another. On this basis the present action would appear to be misconceived because in various different ways it asserts that by involving an underwriter to make a placement of unissued shares and by communicating estimates of profit for the current year to that underwriter, which forecast the underwriter will pass on to a sub-underwriter, that there is a breach of section 128 which breach would permit the plaintiff as the equitable owner of certain shares to restrain the allotment by an injunction [as sought].

Whether the activities of entities such as investment banks and underwriters fall foul of an Act's insider trading provisions, will depend on the specific conduct prohibited by the operative provisions of the regulatory scheme. However, and as far as this work is concerned, there is no reason why, as a general proposition, an investment bank or an entity underwriting an initial public offering, should be allowed to deal with inside information. Underwriters are bound to be incorporated. They are also likely to have access to all the information the issuer itself would have access to, because the issuer would have to make extensive disclosures to the underwriter to procure its services. If underwriters are to market shares on stock exchanges, they must be recognised as insiders.

4 4 4 Chinese walls

A further difficulty in holding companies liable as insiders arises from the fact that companies are materially different from natural persons. The relevant difference is that companies may be made up of divisions. There is, for instance, a widespread practice among financial

[1110] Ibid. 162E–G.
[1111] In agreeing with what was said by Young J in the court below.

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conglomerates to combine advisory business with equities trading. Commercial and investment banks, insurance companies, and securities firms, for instance, engage in 'multi-service activities'.[1112] Each service is provided by a different division. Each division focuses on its activity and the information relevant to it. And, it may be that one division has information about which another knows nothing. If the latter makes a trade in securities about which the former has inside information, the company is strictly to be held guilty of insider trading. In other words, the information known to the one division, is to be attributed to the company as an entity. The Chinese wall defence seeks to address this situation.

A Chinese wall is defined as:

> policies and procedures that are designed to stop the passage of information, especially price-sensitive information, operating between departments within a firm or a financial group.[1113]

It is an information barrier within a corporation, which seeks to leave different departments or sections of the business on 'opposite sides' of the 'wall'. It is created by the implementation of administrative and organisational arrangements and structures, which are designed to stem the flow of information between the different parts of the corporation.[1114]

The use of Chinese walls is a favoured technique of large financial institutions to deal with conflicts of interest.[1115] They are widely used by corporations in Australia, the United Kingdom, the United States, and Canada.[1116] It has been accepted by the courts of these

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[1112] H N Seyhun "Insider Trading and the Effectiveness of Chinese Walls in Securities Firms" (2007) 4 *J L Econ & Pol'y* 369 370.
[1113] Ibid. 369.
[1114] R Cranston *Principles of Banking Law* (1997) 31–2.
[1115] *ASIC* par. 308.
[1116] *ASIC* par. 308 and *Prince Jefri Bolkiah v KPMG* [1999] 2 AC 222 (*Prince Jefri Bolkiah*) 238.

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jurisdictions that Chinese walls 'manage' conflicts;[1117] they do not eliminate them.[1118] Whether a Chinese wall is effective in a particular case, has been held to be a question of fact to be determined on a case-by-case basis.[1119]

For the defence to succeed, the wall must be an 'established part of the organisational structure' of a corporation.[1120] The following organisational arrangements are ordinarily considered in determining whether the wall in the specific case was effective:[1121] the physical insulation of different departments from one another; the education of employees to emphasise the importance of guarding against improperly or inadvertently divulging information; the determination and strict application of procedures to be followed in an instance where the wall is to be crossed or lowered, including the careful keeping of records of such instances; employing a programme that continuously monitors the efficacy of the wall; and employing disciplinary sanction where the wall is breached.

A few examples of the application of Chinese walls in the investment banking sphere will suffice. Investment banks are typically divided into three divisions: investment banking, asset management, and trading.[1122] The investment banking division arranges debt, equity, and convertible instrument financing for corporations and governments. It also advises

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[1117] *ASIC* par. 310 and *Prince Jefri Bolkiah* 238.

[1118] Indeed Bryson J, in *D & J Constructions Pty Limited v Head & Ors trading as Clayton Utz* (1987) 9 NSWLR 118 123, expressed his doubts on whether Chinese walls could serve to prevent improper information flow in certain situations as follows:

> …it is not realistic to place reliance on such arrangements in relation to people with opportunities for daily contact over long periods, as wordless communication can take place inadvertently and without explicit expression, by attitudes, facial expression or even by avoiding people one is accustomed to see, even by people who sincerely intend to conform to control.

Also see the Supreme Court of New South Wales judgment in *Asia Pacific Telecommunications Limited v Optus Networks Pty Limited* [2007] NSWSC 350.

[1119] *ASIC* par. 318.

[1120] *Prince Jefri Bolkiah* 239, quoted with approval in *ASIC* par. 318.

[1121] See *ASIC* par. 319 and *Prince Jefri Bolkiah* 238.

[1122] D P Stowell *Investment Banks, Hedge Funds, and Private Equity* 3ed (2017) 7.

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corporations on mergers and acquisitions.[1123] The asset management division offers equity, fixed income, alternative investment, and money market products and services to, mostly, individual clients. For alternative investment products, the firms co-invest with clients in hedge funds, private equity, and real estate funds.[1124] The trading division sells and trades securities and other financial assets as an intermediary on behalf of institutional investing clients. It normally operates in two business units: the equity and fixed income unit, and the currency and commodity unit. The trading division also provides advice and market research to investing clients.[1125]

In *Re Merrill Lynch, Pierce, Fenner & Smith*[1126] Merrill Lynch employees made selective disclosures to certain of its brokerage clients of negative, material, non-public information learned from one of its investment banking clients. While acting as an underwriter for a proposed offering of convertible debentures of Douglas Aircraft (Douglas), the investment banking division learned that there was a deterioration in Douglas's business outlook. Merrill Lynch did not trade on the information for its own account; the disclosure was made to one of its selected clients. That client sold its Douglas stock just before the publication of the information.

The Commission held that Merrill Lynch had failed to supervise its employees sufficiently. A settlement agreement was reached according to which Merrill Lynch had to adopt a policy prohibiting the disclosure of material information obtained by its underwriting division and anyone outside the division other than senior executives, lawyers of the firm, and other persons

[1123] Ibid.
[1124] Ibid.
[1125] Ibid.
[1126] Exchange Act Rel No 8459 [1967–69 Transfer Binder] Fed Sec L Rep (CCH) 77 629 (Nov. 25, 1968) as cited by T A Levine, A Z Gardiner & L D Swanson "Multiservice Securities Firms: Coping with Conflicts in a Tender Offer" (1988) 23 *Wake Forest L Rev* 41 47.

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with a need to know. In essence the firm had to implement a Chinese wall between the underwriting division and the rest of the firm.

In *Australian Securities and Investment Commission v Citigroup Global Markets Australia Pty Ltd*,[1127] also discussed above,[1128] the defence provided in section 1043F of the Australian Corporations Act[1129] was pleaded. The section is found under the heading 'Chinese wall arrangements by bodies corporate'. It provides:

> A body corporate does not contravene subsection 1043A(1) by entering into a transaction or agreement at any time merely because of information in the possession of an officer or employee of the body corporate if:
> (a) the decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than that officer or employee; and
> (b) it had in operation at that time arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information; and
> (c) the information was not so communicated and no such advice was so given.

At the time of Manchee's trading,[1130] Citigroup Global Markets Australia Pty Ltd was the main operating subsidiary in Australia of an international banking and financial services company, Citigroup Inc. Citigroup carried on various businesses in Australia, including an investment banking business, providing investment banking services within a division established specifically for that purpose. Another division engaged in the trading of securities.

The investment banking division provided Toll with financial advice and other investment banking services. The services were sought specifically in relation to a proposed takeover of

[1127] [2007] FCA 963.
[1128] See p. 165 above.
[1129] Corporations Act of 2001. See R Tomasic, S Bottomley & R McQueen *Corporations Law in Australia* 2ed (2002) 20-9-8.
[1130] See p. 165 above.

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another listed company, Patrick Corporation Limited (Patrick). Citigroup was one of two investment banks appointed by Toll for the takeover. Citigroup's investment banking division was separated from its trading division (and specifically its equity and fixed income unit) by various formal and other information barriers. Manchee was employed in Citigroup's equity derivatives division.

During the day, the head of the team advising and acting for Toll, noticed that Citigoup had engaged in extensive trading in Patrick shares. He, in the investment banking division of the company's Chinese wall (the side privy to the inside information), phoned the head of Citigroup's equities division, who in turn phoned the head of the company's equity derivatives unit, on the public side (the side not privy to inside information) of the company's Chinese wall. It was the head of the equity derivatives unit who asked Manchee to step outside, where he was told to stop buying Patrick shares.

Among the charges brought against Citigroup was that it, rather than its employee, had traded on inside information. Two instances of insider trading were pleaded: the first was about the trading that took place after Manchee was warned not to buy any further Patrick shares. It was common cause that Manchee had not been told that Citigroup was acting for Toll in the takeover of Patrick. The charge rested on the allegation that Manchee held this supposition as a consequence of being warned simply not to purchase further Patrick securities.

The alternative claim was that Citigroup was to be held liable for all the trading that happened on that day before the announcement had been made. According to this charge, the Chinese wall defence was not available to Citigroup. ASIC alleged that certain private side employees of Citigroup had been aware of its acting for Toll and that there was a substantial likelihood that Toll would announce its bid in what was at that time the very near future. Therefore, the purchase and sale by Citigroup of Patrick shares, while some of its employees were in

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possession of inside information, was said to be insider trading.[1131] A central issue that arose in relation to this second charge, was whether Citigroup had made out its defence as required by section 1043 of the Australian Corporations Act.

The functioning of the Chinese wall is well illustrated: the moment the Chinese wall is thought away, the inside information held by the investment banking division is attributed to the whole of Citigroup and more specifically, also to its equity derivatives division. The court upheld Citigroup's Chinese wall defence. In coming to its conclusion, the court analysed whether Citigroup's Chinese walls were adequate to prevent the flow of information from the private to the public side of the company, the side not exposed to the inside information. Jacobson J wrote:

> [T]he communication between Mr Darwell and Mr Manchee, and indeed the earlier communications between Mr Sinclair and Mr Darwell, reveal the potential fragility of Chinese walls. Mr Sinclair reacted very quickly, as a senior and responsible employee, to the news that the public side was trading, in large volume, in Patrick shares. He realised immediately the possible impact of this on the reputation of Citigroup and took steps to find out what had happened. Of necessity, this entailed crossing the Chinese Wall. This very fact of the crossing and the words he used risked sending a tip to those on the public side, but this was unavoidable. Ultimately, it seems to me that the risk of tipping the proprietary trading desk was avoided by the astute way in which Mr Darwell handled the situation and the discreet terms he used in his communication with Manchee. But such a result may not always prevail in the pressurised environment of investment banking.[1132]

An important question that had to be answered about the second insider trading claim against Citigroup was whether Citigroup had indeed employed 'arrangements that could reasonably [have been] expected to [have] ensured that the information was not communicated' from those in the know to the person who traded. In other words, whether Citigroup had indeed employed a sufficiently efficient Chinese wall. As is clear from section 1043F above, in order for defendants to make good their Chinese wall defence, they must convince a court, subsequent

[1131] The court also had to deal with whether the information was 'generally available' and whether a reasonable person would have expected it to have a 'material effect' on the price of Patrick shares.

[1132] *ASIC* par. 522–525.

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to a case of insider trading being made out against them, that the facts of application to the impugned transaction or agreement satisfy each of the three requirements in subsections (a) to (c). In ASIC, it was not in issue that Citigroup satisfied the requirements in subsection (a) and (c). The Securities Investment Commission took aim at Citigroup's implementation of the requirement in subsection (b). They argued that, firstly, Citigroup's Chinese wall defence had to fail as it had no mechanism in place to have brought a trader such as Manchee 'over the wall'.[1133] This line of attack was supported by the ad hoc nature of what took place when the private side became aware of Mr Manchee's trading.[1134]

The court found in favour of Citigroup. The company had policies in place that required private side employees not to communicate inside information to persons on the public side, without involving legal and compliance personnel to assess the materiality of the information and, when appropriate, to implement 'wall crossing' procedures.[1135] The court further found that it was impossible to ensure that every conceivable risk is covered by company procedures and that they are followed by employees.[1136] It held that section 1043F(b) did not require 'absolute perfection', and that the standard was objective and related merely to 'arrangements that could reasonably be expected to ensure that the information was not communicated' across the wall.[1137]

While the court in *ASIC* was willing to accept Citigroup's arrangements as sufficient, the practical implementation of an effective Chinese wall may be difficult.[1138] In especially the English courts and regulatory institutes, the concept of a Chinese wall has been met with some scepticism. The scepticism is attributable to the defence's reliance on human integrity and the

[1133] Ibid. par. 586.
[1134] Ibid. par. 587.
[1135] Ibid. par. 589.
[1136] Ibid. par. 591.
[1137] Ibid. par. 591.
[1138] R Jooste "A Critique of the Insider Trading Provisions of the 2004 Securities Services Act" (2006) 123 *S African LJ* 437 440–441.

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ability of organs of corporate institutions to contain the flow of information.[1139] The strongest judicial pronouncement to this effect is found in *North and South Trust Co v Berkeley* where it is written:

> How do you train anyone to act properly in such a situation? What course of action can possibly be adopted which does not involve some breach of duty to one principle or the other . . . neither skill nor dishonesty can reconcile the irreconcilable.[1140]

Some academic commentators have expressed equally harsh scepticism about the effectiveness of Chinese walls.[1141]

The Financial Markets Act, notwithstanding the fact that it holds companies liable for insider trading, does not provide for a Chinese wall defence. Indeed, the King Task Group initially excluded the possibility of corporations being liable as insiders for insider trading as a result of the lack of jurisprudence on such a defence in South Africa.[1142] Not much thought went into the Task Group's reasoning. At the time that they considered the Chinese wall defence, insider trading itself was hardly mentioned in the law reports.

Be that as it may, the legislature has now again broadened the scope of the term 'insider' to include corporations. Jooste is of the opinion that the legislature has failed to apply its mind to the possibility of including the defence.[1143] He sees the lack of the defence as a serious flaw in our legislative provisions. He argues that the absence of the defence could be detrimental to the efficacy of the operation of financial institutions such as merchant banks and stockbroking firms.[1144]

[1139] Jooste (2006) *S African LJ* 440.
[1140] [1971] 1 All ER 980. As cited by Jooste (2006) *S African LJ* 440.
[1141] See Seyhun (2008) *J L Econ & Pol'y* 369 and Levine, Gardner & Swanson (1988) *Wake Forest L Rev* 41.
[1142] King Final Report as cited by Jooste (2006) *S African LJ* 439.
[1143] Jooste (2006) *S African LJ* 440.
[1144] Ibid.

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It could well be argued that, if the corporation is to be seen as just another trader in the financial markets, it cannot through a subdivision afford itself the benefit of a defence not available to other market participants. In other words, the information obtained by one part of an institution must be regarded as information known by the institution as a whole.[1145] Whereas it strictly falls outside the scope of this thesis, it must be said that there is no principle-based reason why the legislature has not or should not have provided for the defence. The nature of a corporation as opposed to a natural person dictates that the defence is a necessary accompaniment to the possibility of corporate liability for insider trading.[1146] Other than a natural person, there is more than one mind at work within a corporation. Pragmatism requires a defence to be afforded to a corporation where the mind holding the inside information is properly separated from the mind that decides to initiate a trade. This is reconcilable with the equal access theory's premise that the wrongfulness of insider trading lies in knowingly trading with information to which the rest of the public cannot lawfully have access.

4 4 5 Conclusion

The Financial Markets Act rightly includes corporations within its definition of insider. Yes, holding corporations liable for insider trading does present further difficulties legislatures must overcome in formulating what the prohibited conduct within an insider trading regime is to be. However, as is clear from the European Union's nuanced approach to buy-backs and the recognition of the Chinese wall defence generally, those difficulties are not insurmountable. The Chinese wall defence addresses the difficulties presented by the fact that companies may be divided into divisions, each with its own store of knowledge. Those difficulties are not sufficient reason not to hold companies liable as insiders. As a starting point, companies must be recognised as insiders. They must be subject to the insider trading prohibitions. The principles of the equal access to information theory dictate that that must be so. Its uniform

[1145] Ibid.
[1146] Ibid.

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application must trump any suggestion that companies should not adhere to the insider trading provisions.

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4 5 Steps in the right direction: an insider is a person with inside information

The Australian, New Zealand, and European Union legislatures have recently enacted definitions of 'insider', which takes a step toward basing the definitions of insider on the equal access theory. These are steps in the right direction. The legislatures have, however, not completed the paradigm shift.

4 5 1 Australia

In Australia, certain aspects of the *Percival v Wright* rule were reversed in 1958,[1147] with uniform legislation prohibiting trading on inside information by directors enacted by 1962.[1148] The focus was on directors. They were prohibited from using information obtained by virtue of their offices.[1149] The approach was followed in subsequent legislation.[1150] The Australian securities market experienced a boom in the late 1960s as large deposits of iron, copper, and aluminium were found in the country. Many a company issued securities, and the secondary market experienced high trading volumes.[1151] With the heightened activity came a heightened rush for speculative short-run profits, and allegations of market malpractices, including trading by individuals with information ascendancies, abounded.[1152]

[1147] Section 107 of the Victorian Companies Act of 1958.

[1148] Section 107 of the Victorian Companies Act of 1958 inspired section 124(2) of the Australian Uniform Companies Act of 1961. (Loke (2006) *Am J Corp L* 138 footnote 56.) As the name suggests, the Act was the result of an effort to establish uniform company legislation for the whole of Australia. By 1962, every state in the Australian federation had passed a Companies Act based on the Uniform Act.

[1149] Section 124(2) of the Australian Uniform Companies Act of 1961 provided: 'An officer of a corporation shall not make improper use of information acquired by virtue of his position as such officer to gain directly or indirectly an advantage for himself or for any other person or to cause detriment to the corporation'.

[1150] See section 229(3)-(4) of the Australian Companies Act of 1981 and section 232(5)-(6) of the Corporations Act of 1989.

[1151] Loke (2006) *Am J Corp L* 148.

[1152] Ibid. 148-9.

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The federal government initiated a study into the legal regulation of Australia's securities markets.[1153] Four of the country's states had enacted similar legislation aimed at regulating the securities industry by the end of 1971.[1154] These legislative provisions, all still contained in company legislation as opposed to financial market legislation, were still firmly grounded in the fiduciary doctrine.[1155]

The United Kingdom's misappropriation approach had a strong influence on Australian securities law for historical reasons.[1156] The approach provided the foundation for many Australian legislative provisions.[1157] Prosecutors struggled to establish that trader's learned inside information in their capacities as connected persons. This failure, to establish a link with the issuing company in cases where the accused knew inside information at the time of the trade, gave rise to results irreconcilable with the promotion of the integrity of the capital markets. One example, *Darvall v Lanceley*,[1158] will suffice.

[1153] Ibid. 149 at note 111 notes that the federal response was prompted by allegations of insider trading involving a mining company called Poseidon NL. It had announced significant findings of nickel and copper at its mines in Western Australia. The complaints came to the attention of the leader of Australia's official political opposition at that time who tabled a resolution for an inquiry into setting up a securities and exchange commission aimed at acting against trading on inside information. The committee submitted its final report in 1974 under the title *Australian Securities Markets and their Regulation: Report from the Senate Select Committee on Securities and Exchange*.

[1154] Loke (2006) *Am J Corp L* 149.

[1155] For instance, a new section 124A(1) was added to Victorian Companies Act of 1971. It provides:

> An officer of a corporation who in or in relation to a dealing in securities of the corporation by himself or another person makes use to gain directly or indirectly an advantage for himself or another person of specific confidential information by virtue of his position as such an officer which if generally known might reasonably be expected to affect materially the value of the subject matter of the dealing is liable to a person for loss suffered by that person by reason of the payment by him of a consideration in respect of the securities greater than the consideration that would have been reasonable if the information had been generally been known at the time of the dealing.

[1156] See Loke (2006) *Am J Corp L* 151. Loke uses the phrase 'information approach' for what this thesis describes as the misappropriation theory.

[1157] See section 112 of the New South Wales Securities Industry Act of 1975; section 112 of the 1975 Victorian Securities Industry Act of 1975; section 128 of the Commonwealth's Securities Industry Act of 1980; and section 1002 of the Corporations Law of 1989.

[1158] See for example *Darvall v Lanceley* (1986) 10 *ACLR* 893.

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In *Darvall* injunctive relief was sought to restrain the plaintiff from contravening the relevant insider trading provisions.[1159] The relief sought arose from two competing takeover bids. Darvall had made offers to his fellow shareholders of a company called Norbrik to purchase all or any of their shares for $10 each, subject to certain conditions. Three days after this, Lanceley made an unconditional offer to Norbrik's shareholders to purchase their shares for $12 each. Seeking the relief against him, Lanceley alleged that Darvall was breaching the relevant insider trading prohibition and should therefore be, in South African legal terms, 'interdicted' from dealing with Norbrik's shares.[1160] The basis upon which the relief was sought was that Darvall, as a shareholder of Norbrik, had had access to information about a joint venture agreement into which the company was about to enter. It was common cause that Darvall had obtained the information in the process of bringing a court application against one of Norbrik's directors.

The court found that as the information had come into his possession in the process of making the application, and not by reason of his status as a shareholder of Norbrik, the relief sought against him could not be granted.[1161] The court found that Darvall was not associated with the company and, for that reason, there was no case against him.[1162] According to the court, Darvall would have been perfectly within his rights to purchase all his fellow shareholders' shares, notwithstanding the fact that he was in possession of inside information. He was not prohibited from doing so for the reason that he had not received the information in a capacity identified by the relevant legislation as being prohibited from trading on inside information.[1163]

The legislative provisions dealt with in cases like *Darvall* were found to be unsatisfactory largely as a result of their complexity. According to the Australian Griffiths Committee's

[1159] The relief was sought in terms of a counterclaim.
[1160] Ibid. 723G.
[1161] Ibid. 725A–B.
[1162] Ibid. 725D–E.
[1163] Ibid. 725D–E.

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(Griffiths Committee) 1989 report, with the self-explanatory title 'Fair Shares for All: Insider Trading in Australia' (Fair Shares for All), this complexity was brought about by the misappropriation theory's straddling of two legislative worlds.[1164] This, together with public outcries over perceived insider trading during and before the bursting of a stock market bubble in Australia in the 1980s, called for action.[1165] Fair Shares for All resulted in an emphasis shift in trading on inside information regulation in Australia. It provides that:

> The offence of insider trading must have its genesis in the use of information derived from within the company. *The existing prohibition requiring a person to be connected to the corporation which is the subject of the information unnecessarily complicates the issue. It is the use of the information, rather than the connection between a person and a corporation, which should be the basis for determining whether insider trading has occurred*. Concurrently, it should be placed beyond doubt that the provisions extend to corporations as well as to natural persons.[1166] (Emphasis added.)

The report recommended that the insider trading provisions be amended to provide that:

> 'a person (including a corporation) who is in possession of inside information, and who knows or ought reasonably to know that it is inside information, shall not use that information to trade in or subscribe for the securities of the company which is the subject of the information.'[1167]

The Griffiths Committee held that the fiduciary duty doctrine and the misappropriation theory were redundant for the purposes of regulating insider trading. It stated that:

> insider trading legislation should not be based on any theory which may limit the scope of the prohibition, either by some concept of fiduciary duty or a theory of misappropriation. . . . Rather, it must be emphasised that the basis for the regulation of insider trading is the need to guarantee investor confidence in the integrity of the securities markets. Accordingly, the Committee confirms the principles adopted in 1981 by the Committee of Inquiry into the Australian Financial System (the Campbell Committee) as a basis for the prohibition on insider trading:

[1164] Australian House of Representatives Standing Committee on Constitutional and Legal Affairs (the Griffiths Committee) *Fair Shares for all: Insider Trading in Australia* (November 1989) (*Griffiths Report*) par. 4.3.5.

[1165] Loke (2006) *Am J Corp L* 152. For another discussion of insider trading regulation in Australia up to 1987 see K J Bennets "Regulation of Insider Trading: The Australian Experience" (1987) 3 *Canterbury L Rev* 254.

[1166] *Griffiths Report* XV.

[1167] Ibid.

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> The object of restrictions on insider trading is to ensure that the securities market operates freely and fairly, with all participants having equal access to relevant information. Investor confidence, and thus the ability of the market to mobilise savings, depends importantly on the prevention of the improper use of confidential information.[1168]

The recommendations of the Griffiths Committee were in large part accepted by the Australian Government[1169] and the Australian Corporations Act was amended accordingly.[1170] In essence, as one would expect from an equal access to information approach, the insider trading provisions were amended to remove the requirement for a person in possession of inside information to be connected to the company to which the information relates; corporations

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[1168] *Griffiths Report* 17.

[1169] M Duffy *Government Response to the Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs entitled 'Fair Shares for All: Insider trading in Australia* (October 11, 1990.). Also see Loke (2006) *Am J Corp L* 153. In an Explanatory Memorandum to the Bill (*Explanatory Memorandum*) circulated under the Authority of the Attorney General of Australia the following was said at par. 34–37:

> 34. Insider trading has become a matter of increasing concern within the securities industry and amongst the wider community, contributing to the deterioration of public confidence in the securities markets more generally.
>
> 35. The report of the House of Representatives Standing Committee on Constitutional and Legal Affairs (the Griffiths Committee) "Fair Shares for all: Insider Trading in Australia" in November 1989, recommended significant reform in relation to the legislation and administrative actions regarding the enforcement of the existing insider trading provisions. The Government response to the Report, tabled on 11 October 1990 accepted the majority of the Committee's recommendations for legislative amendments, and in December 1990 draft legislation and an accompanying explanatory paper was released for public exposure.
>
> 36. The provisions in this Bill represent the outcome of the Government's consideration of that report in the light of the public submissions on the exposure draft.
>
> 37. The key elements of the provisions are that: the definition of an 'insider' will encompass corporations as well as natural persons; and there will be no need for the prosecution to establish a connection between the person in possession of inside information and the company to which the information relates: instead the proposed provision will prohibit any person, including a tippee, who is in possession of inside information using it to trade in or subscribe for securities in the company; a statutory definition of inside information is to be included, based on a "reasonable person" test: information will be defined as being generally available where it is disclosed in a manner which would, or would be likely to, bring it to the attention of persons who commonly invest in securities of a kind whose price or value might be affected by the information, and where a reasonable period of time for the dissemination of information has elapsed.

[1170] See section 8 and schedule 4 of the Corporations Legislation Amendment Act 1991.

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were included in the definition of insider; and the definition of inside information, onto which the focus shifted, was fine tuned.[1171]

The enactment of the Corporations Legislation Amendment Act of 1991 was a consequence of the adoption of several recommendations made in Fair Shares for All. The insider element had been removed from the law relating to trading on inside information.[1172] Section 1002G of the Australian Corporations Act as it then read provided:

(1) Subject to this Division, where:
  (a) a person (in this article) called the 'insider' possesses information that is not generally available but, if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of securities of a body corporate; and
  (b) the person knows, or ought reasonably to know, that:
    (i) the information is not generally available, a reasonable person would expect it to have a material effect on the price or value of securities of a body corporate; and
    (ii) if it were generally available, it might have a material effect on the price or value of those securities.

The Australian courts initially were reluctant to recognise the equal access to information approach inherent in their legislature's new definition of insider. In *Exicom Pty Ltd v Futuris Corporation*[1173] the Supreme Court of New South Wales was confronted with a scenario in which inside information was exchanged between companies in order for the one to raise further capital. Exicom was thought to be undercapitalised and it was decided that it needed a new injection of equity capital. It sought advice and possible offers for taking up shares in the company from various entities. Those entities used the information gathered to purchase

[1171] See *Explanatory Memorandum* par 37. On the evolution of the thinking on insider trading in Australia see A Black "The Reform of Insider Trading Law in Australia and the Scope of Section 128 of the Securities Industry Code" (1992) 15 *New South Wales LJ* 214.
[1172] See R Baxt, A Black & P F Hanrahan *Securities and Financial Services Law* 6 ed (2003) 503–504.
[1173] (1995) 123 FLR 394.

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shares on the open market. The court was approached by Exicom to stop further use of the inside information.

The court held that the Australian Corporation's Act's provisions were aimed at protecting members of the public taking part in the financial markets against insiders.[1174] Referring to what it called the '1933 laws in America' it held that the approach of those laws, like the Australian provision, has been primarily to 'prevent, as much as possible, ingenious schemes being concocted by entrepreneurs to escape regulation'.[1175] The enactments before the court, held Young J, continued in the tradition of the previous Australian provisions.[1176] He wrote further:

> Mr Jucovic QC sought to address the mischief to which the division was directed. The vice, he said, is that a person who has information is dealing in the market with a person who does not have the information. It seems to me that this is the correct way of approaching the construction of [the section]. *Again, it must be remembered that the theory behind insider trading is breach of fiduciary duty*. (Emphasis added)

Young J erred. Still influenced by the old regime, Young J found that there was no breach of the Australian insider trading provisions as they were based on the fiduciary duty doctrine. He also held that a company cannot be an insider of itself as 'the whole genesis of this aspect of the law from the law of fiduciary obligation shows that one does not owe a fiduciary obligation to oneself'.[1177]

In *R v Firns*,[1178] the court continued down the same path. Mason P acknowledged that '[t]here is an involved philosophical debate about the object of regulating insider trading' and that,

[1174] (1995) 123 FLR 394 397.
[1175] Ibid.
[1176] In making this statement, the court referred to the case of *Hooker Investments Pty Ltd v Baring Brothers Halkerston & Partners Securities Ltd* (1986) 10 ACLR 462, and on appeal *Hooker Investments Pty Ltd v Baring Bros Halkerston & Partners Securities Ltd (No 2)* (1986) 5 NSWLR 157.
[1177] *Exicom Pty Ltd v Futuris Corporation* (1995) 123 FLR 394 399.
[1178] (2001) 38 ACSR 223.

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because of this, 'care needs to be taken to ensure that a judge does not unconsciously read his or her own philosophy into the enactment and then use it as a basis for construing the enactment consonant with that philosophy'. Then Mason P did just that. He wrote that, 'in my opinion the market fairness/equal access paradigm cannot be invoked as the sole basis for interpreting the criminal offence'. Mason P erred in following judgments handed down prior to Fair Shares for All and the enactment of what was then the new Australian provisions.

Sections 1043A–1045A of the Australian Corporations Act 2001 are now, in any event, clear. Section 1043A(2) of the Australian Corporations Act 2001 now provides as follows:

> (2) Subject to this Subdivision, if:
>
> (a) a person (the insider) possesses inside information; and
>
> (b) the insider knows, or ought reasonably to know, that the matters specified in paragraphs (a) and (b) of the definition of inside information in section 1042A are satisfied in relation to information; and
>
> (c) relevant Division 3 financial products are able to be traded on a financial market operated in this jurisdiction;
>
> the insider must not, directly or indirectly, communicate the information, or cause the information to be communicated, to another person if the insider knows, or ought reasonably to know, that the other person would or would be likely to:
>
> (d) apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products; or
>
> (e) procure another person to apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products.

The Australian legislature's intention has been fully accepted and placed beyond doubt.[1179] The Supreme Court of Western Australia has held that the labelling of a person as 'the insider'

[1179] *R v Mansfield* (2011) WASCA 132 par. 56–57 where some of the recommendations of the *Griffiths Report* and the *Explanatory Memorandum* are discussed.

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in section 1043A(1)(a) has the potential to mislead,[1180] and that the Australian insider trading provisions apply to all persons, regardless of whether the inside information was obtained by or from a person connected with the corporation whose securities are traded in the impugned transaction.[1181] The equal access to information theory is now employed to protect the capital markets of Australia. There are, however, still judgments emanating from the Australian courts that show evidence of fiduciary doctrine influence.

In *R v O'Brien*[1182] the accused was employed first by a Computershare Investor Services (Pty) Ltd, a firm that was engaged in a range of investor services to corporations and shareholder groups. During the time of committing his offence, he was transferred to a subsidiary of Computershare, Georgeson Shareholder Communications Australia (Pty) Ltd, where he a held a senior position as director of business development until his employment was terminated.[1183]

Georgeson specialised in providing strategic shareholder consulting services to corporations and shareholder groups, particularly in relation to 'extraordinary transactions',[1184] such as mergers and acquisitions, takeovers, corporate restructures and capital raising.[1185] O'Brien, being the director of business development, was responsible for identifying and procuring sales opportunities, either through the existing client base or by offering services to companies identified through announcements on the Australian Securities Exchange. His role included communicating directly with existing or prospective clients about relevant extraordinary transactions.[1186] The proposals Georgeson submitted to its clients for the use of Georgeson's services included standard terms and conditions where Georgeson and its employees

[1180] *R v Mansfield* (2011) WASCA 132 par. 8.
[1181] Ibid par. 8.
[1182] *R v O'Brien* [2011] NSWSC 1553.
[1183] Ibid. par 6.
[1184] Ibid. par 8.
[1185] Ibid. par 8.
[1186] Ibid.

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undertook to 'keep confidential' and not use for any purposes other than the provision of those services, information gained from a client.[1187]

The court found that it was by virtue of O'Brien's position at Georgeson (including his attendance of meetings, reading a shared network drive folder, and communicating with clients) that he routinely acquired information about what was at the time 'proposed forthcoming extraordinary transactions',[1188] which, if carried out, would have an effect on the price of the financial products concerned.[1189] Certain facts weighed with the court as relevant to a consideration of the seriousness of O'Brien's conduct. Among these were, first, the fact that O'Brien was the director of business development in Georgeson and could therefore be regarded as a 'true insider'.[1190] Second, the fact that O'Brien was at all relevant times aware of his obligations of confidentiality and that his conduct could be properly characterised as a breach of trust.[1191]

From the court's reasoning it seems as if insider trading that includes a breach of a fiduciary duty is seen as a more serious offence than any other 'type' of insider trading. For the court held:

> I would assess the objective seriousness of these offences to be at the lower end of the range for offences of this kind. I have reached that conclusion for a number of reasons. While the offender was a "true insider" the level of his involvement was significantly less than, for example, that of a director of one of the participating companies in the transaction.[1192]

[1187] Ibid. par 9.
[1188] Ibid. par 10.
[1189] Ibid.
[1190] Ibid. par 51.
[1191] Ibid.
[1192] Ibid. par 67

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The court's reasoning finds no basis in the statutes before it. The prohibition in section 1043A applies to all persons regardless of whether the inside information was obtained by or from a person connected, directly or indirectly, with the corporation whose securities are traded.[1193]

The Australian legislature has kept in its insider trading provisions the concept of tipping.[1194] This is perplexing. Where does tippee liability fit into the equal access to information doctrine? According to the Court of Criminal Appeals, New South Wales, in *Khoo v The Queen*[1195] under a regime in terms of the equal access to information theory 'tipping is arguably a more serious threat to the integrity of the securities market than actual trading. . . . [F]or the more widespread it becomes the greater will be the potential for trading'.[1196] Tipping, says the court, is the more 'open-ended violation' as opposed to an insider entering the market, who trades on his own account and then leaves the market.[1197] It was further said that the harm of tipping lies in the fact that it further causes an unequal dissemination of information.[1198]

The line of reasoning was maintained in the bail application reported as *R v Khoo*.[1199] The main argument was that the tipping offence is in some way to be regarded as falling within a lesser class of offence.[1200] The court in principle accepted the fact that a tippee does not in a specific case make a financial gain for himself, and that this is relevant at the sentencing stage of a tipping prosecution. However, the argument that tipping was somehow a lesser offence was, as it had been before the sentencing court, again rejected. Tipping, said the court, is more serious than trading on inside information. The court held:

1193 Ibid.
1194 See p. 310 above.
1195 [2013] NSWSC 323.
1196 Ibid. par 7.
1197 Ibid. par 8–9.
1198 Ibid. par 10.
1199 [2013] NSWCCA 1518.
1200 Ibid. par 30.

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> The sentencing Judge took into account (in my view correctly) that a particular mischief of tipping is that it places the tippee in the position of having information with the potential for it to be further communicated to others. If a person in the Applicant's position engages in insider trading, that may be the extent of the actual damage done. However, here the tipper is communicating information in a way which places the market at direct risk (at the hands of the tippees). And undermines the integrity of commercial arrangements. This conduct also exposes the market to further risk if the tippees share the information with others.[1201]

This line of reasoning is unconvincing. It could just as easily be argued that tipping creates a more equal dissemination of information as more people are privy to the inside information.[1202] It is more correct to say that tipping in all probability causes more trades in which one party is unfairly advantaged.

In *R v Fysh*[1203] it was recognised that the insider trading provisions in the Australian Corporations Act were enacted with the object of promoting fair, orderly and transparent markets for financial products.[1204] It is simply the acquisition or disposal of shares by people having the unfair advantage of insider information that is inimical to promoting fair, orderly and transparent markets for financial products. It is that conduct which has the capacity to unravel the public trust that is the lifeblood of the market. A clear exposition of the equal access to information is given in the judgment where it is said:[1205]

> The rationale for criminalising insider trading is simple. A predicate of a fair and transparent market is equal access to price sensitive information. Access to inside information is, of its nature, unequal. The vice of unequal access to price sensitive information is not removed by the existence of an independent motive or 'previously identified strategy' that prompts the acquisition of the relevant financial products. Public trust in a fair and transparent market can only be served by immunising the

[1201] Ibid. par 37.
[1202] Ibid. par 74.
[1203] (No 4) [2012] NSWSC 1587.
[1204] Ibid.
[1205] Ibid. par 47.

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> market from the prospect of any trading by people on the inside, who have the unfair advantage of knowing something the market cannot know.

4 5 2 New Zealand

The New Zealand courts, without the intervention of the legislature, recognised that the rule in *Percival v Wright* does not reflect modern thinking on the regulation of directors' conduct. The jurisdiction has also been on the forefront of recognising insider trading as a market wrong.

In *Coleman v Myers*[1206] the facts are briefly as follows.[1207] The plaintiffs were the minority shareholders in a small private company. They reluctantly sold their shares to Myers, the company's managing director. Myers had made a takeover offer in terms of which he would acquire the company's entire equity capital. As soon as Myers became the sole shareholder, he liquidated some of the company's surplus assets and declared a dividend, which more than reimbursed his acquisition expenses. The plaintiffs contended that their shares had been acquired by Myers at a gross undervaluation through a scheme by which the true value of the company's shares was concealed. One of the assertions made in the statement of claim was that Myers and his co-director should have disclosed 'all the relevant information in their possession having a bearing on the fair price of the shares'.[1208] Myers and his co-director sought to rely on the fact that *Percival v Wright* had never been questioned in New Zealand. In the trial court Mahon J held that *Percival* was wrongly decided. The judge wrote as follows:

> In the present case, which is the case of a private company with unlisted shares, it seems an untenable argument to suggest that the shareholders on offer to buy their shares are not perforce constrained to repose special confidence in the directors that they will not

[1206] The judgment of the court of first instance (the Supreme Court of Auckland) is reported at [1977] 2 NZLR 225 ('*Coleman* a quo') and the judgment of the court of appeal (the Court of Appeal Wellington) at [1977] 2 NZLR 297 ('*Coleman* appeal'). For a discussion of the case see B A K Rider "Percival v Wright. Per Incuriam." (1977) 37 *Mod L Rev* 471 471–472.

[1207] The facts are stated here as they were confirmed by the court of appeal.

[1208] *Coleman* a quo 266.

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> be persuaded into a disadvantageous contract by non-disclosure of material facts. In my opinion, therefore, there is inherent in the process of negotiation for sale a fiduciary duty owing by the director to disclose to the purchaser any fact, of which he knows the shareholder to be ignorant, which might reasonably and objectively control or influence the judgment of the shareholder in forming his decision in relation to the offer. The application of the rule so assumed to exist must necessarily be confined to private companies and to such transactions of compliance with the duty of disclosure. Thus in the case of stock exchange purchases and sales the regulation of insider trading must be left to the legislature.
>
> . . . .
>
> Applying such considerations to the problem at hand, I reach the unhesitating conclusion that the decision in *Percival v Wright*, directly opposed as it is to prevailing notions of correct commercial practice, and being in my view wrongly decided, ought no longer to be followed in an impeached transaction where a director dealt with identified shareholders. I accordingly accede to the submission of Mr Wallace that on the facts of this case, where the director of a private company made an offer to shareholders to purchase their shares, he had a duty to disclose to such shareholders any material fact of which to his knowledge they were unaware, and which reasonably might, from an objective viewpoint, materially affect the decision of those shareholders as to whether they would sell or as to the terms of sale.[1209]

On appeal, the judgment of the court *a quo* was overturned to a certain extent. The court of appeal, while noting that it was unclear whether Mahon J indeed did so, found that it was unnecessary to lay down a general rule applicable to, at least, directors of private companies with unlisted shares.[1210] It held that a fiduciary duty is something that arises out of the particular circumstances of a specific case. As a result of the specific facts in *Coleman*, found the court of appeal, the directors did owe a fiduciary duty to, and were prohibited from trading with, the shareholders.[1211] These facts were the familial character of the company, the position of the buyer of the shares in the company, the extent of the inside knowledge in possession of the buyer, the way in which the takeover was executed, the way in which the shareholders were persuaded to sell their shares, and the fact that the only director that could stand in the

[1209] *Coleman* a quo 278 and 280.
[1210] *Coleman* appeal 330.
[1211] Ibid. 330.

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way of the takeover was removed from the board before the formal take-over offer was made.[1212] The court found that:

> at all material times the respondent directors had, and emphasized that they had, inside knowledge of the company's affairs; while the son certainly and the father probably had intimate knowledge of the detailed plan of acquisition and all its advantages and implications. In the light of the history and character of the company and their offices as chairman and managing director. . . they were in a position where confidence had to be placed in them. And in the negotiations and recommendation they invited that confidence. Any suggestion that in the matter of selling shares to the shareholders they were able to negotiate effectively at arm's length would be unreal.[1213]

The court held that directors in general were free to profit from their positions, as there was nothing in principle that prohibited directors from profiting in the dealings with their shareholders.[1214] As to the obligations that rested on directors, it was held that:

> in the setting here there must be an obligation not to make to shareholders statements on matters material to the proposed dealing which are either deliberately or carelessly misleading. And in my opinion there must at least be an obligation to disclose material matters as to which the director knows or has reason to believe that the shareholder whom he is trying to persuade to sell is or may be inadequately informed.[1215]

The court defined 'material matters' broadly, holding that they are considerations that can reasonably be said to be likely materially to affect the mind of one of the parties to the transaction.[1216]

The court of appeal, like the court *a quo*, found for the sellers of the shares, but on a much narrower basis. The judgments were a recognition of a common law cause of action allowing a shareholder, in certain circumstances, to recover losses from a director of a company, where the director purchased shares from the shareholder while having inside information not available to the shareholder. One of the material facts required in terms of the cause of action

[1212] Ibid. 330 - 331.
[1213] Ibid. 331.
[1214] Ibid. 333.
[1215] Ibid. 333.
[1216] Ibid. 333.

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is, however, that there is a fiduciary relationship between the parties to the transaction, and this relationship would arise only on the special facts of the case.

Until the enactment of the Securities Amendment Act of 1988 there was no specific legislative provisions on New Zealand's statute books that dealt with insider trading. The New Zealand government became concerned about the state of its securities markets in the 1980s.[1217] Its first insider trading legislation adhered to the fiduciary duty doctrine, requiring a connection between the insider and the public issuer of the shares.[1218] The New Zealand legislature was initially influenced strongly by United States jurisprudence.[1219]

The 1988 New Zealand Act defined an 'insider' as meaning:

> in relation to the public issuer,
>
> - the public issuer itself;
> - a director or employee or substantial security holder of the public issuer who has inside information about the public issuer or another public issuer by reason of their position with the public issuer; or
> - a person who receives in confidence insider information about the public issuer or another public issuer from any of the persons referred to above (or from a person who has received the information in confidence from any of the persons referred to above).

The New Zealand regime, in this way, defined a primary insider as a person who has a relationship with the issuer and who has information by reason of that relationship. Secondary

[1217] New Zealand Ministry of Economic Development *Reform of Securities Trading Law: Volume One: Insider Trading: Fundamental Review (Discussion Document)* (2002) ("*New Zealand Review*") 21.
[1218] Ibid. 21.
[1219] Ibid.

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insiders, or tippees, were defined as, and limited to, persons who obtained inside information in confidence from either a primary or a secondary insider.[1220]

In 2002 New Zealand's Ministry of Economic Development published a discussion document proposing certain reforms in their securities trading law. It specifically dealt with a fundamental review of their laws dealing with insider trading. The review was prompted by a perception that, amongst other things, there were problems with the substantive legislation contained in the New Zealand Securities Amendment Act of 1988.[1221] Specifically, it was felt that the legislative regime did not capture the type of behaviour that was perceived by the public to be wrongful insider trading and that a review going right to the basis of insider trading regulation was necessary.[1222] It further found that the definitions of primary and secondary insiders were long and overly complex. This resulted in technical arguments being made by defendants. It created loopholes for dealers with inside information to avoid the prohibitions.[1223]

The New Zealand legislature therefore found their insider trading law, including the requirement that the insider must have a relationship with the public issuer, to be complex, difficult to enforce, and leaving many opportunities to avoid the prohibition.[1224] It adopted a regime similar to that of Australia, focusing on the threat that trading on inside information poses to confidence in the market and its integrity, rather than on a breach of duty owed to an issuer.[1225] The proposal was aimed at applying to any person who trades in shares having information that is not generally available to the public.[1226] It proposed a new section 8A, creating a new definition for the term 'information insider'. The new definition shifts the

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[1220] Ibid. 29.
[1221] Ibid. 7.
[1222] Ibid.
[1223] Ibid. 29.
[1224] Explanatory note to the Securities Legislation Bill 2006 (2006 NZ Securities Legislation Bill) 3.
[1225] Ibid. 3.
[1226] Ibid.

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emphasis to the information that the insider possesses, rather than the position the insider occupies. An information insider is now anybody with the requisite knowledge. The insider may be a person with no connection to the public issuer in question.[1227]

Section 8A of the New Zealand Securities Markets Act,[1228] under the heading '[w]ho is an information insider', now quite simply provides:

> (1) A person is an information insider of a public issuer if that person—
> (a) has material information relating to the public issuer that is not generally available to the market; and
> (b) knows or ought to know that the information is material information; and
> (c) knows or ought reasonably to know that the information is not generally known to the market.
> (2) A public issuer may be an information insider of itself.

4 5 3 The European Union

Article 2 of the European Insider Dealing Directive of 1989 provided as follows:[1229]

> 1. Each Member State shall prohibit any person who:
> - by virtue of his membership of the administrative, management or supervisory bodies of the issuer,
> - by virtue of his holding the capital of the issuer, or
> - because he has access to such information by virtue of the exercise of his employment, profession or duties,
>
> possesses inside information from taking advantage of that information with full knowledge of the facts acquiring or disposing of for his own account or for the account of a third party, either directly or indirectly, transferrable securities of the issuer or issuers to which that information relates.
>
> 2. Where the person referred to in paragraph 1 is a company or other type of legal person, the prohibition laid down in that paragraph shall apply to natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned.

[1227] Ibid. 14.
[1228] Securities Markets Act 234 of 1988.
[1229] Council Directive 89/592/EEC of 13 November 1989 O J L334/30 (1989 Directive).

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> 3. The prohibition laid down in paragraph 1 shall apply to any acquisition or disposal of transferable securities effected through a professional intermediary.

Article 4 of the 1989 Directive also provided that:

> Each Member State shall also impose the prohibition provided for in Article 2 on any person other than those referred to in that Article who with full knowledge of the facts possesses inside information, the direct or indirect source of which could not be other than a person referred to in Article 2.

Persons who possess non-public information were divided into two categories:[1230] primary insiders and secondary insiders. Primary insiders were defined as those persons who had acquired inside information as a result of their employment or other direct positional access to the source of the information.[1231] Secondary insiders were defined as those persons who had obtained the inside information, but not as a result of a special relationship, from a source who was a primary insider.[1232]

Primary insiders were prohibited from either trading or tipping, whereas secondary insiders were prohibited from trading but not from tipping.[1233] At the time Hazen remarked that this was probably due to the practical difficulties of detecting and successfully prosecuting remote tipping of non-public information.[1234] The different tipping rules may have reflected an attempt to balance the need for effective insider trading enforcement against the risk of establishing too broad a prohibition. He submitted that consistency requires extending the tipping prohibition to remote parties, at least to those who knowingly made selective disclosure

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[1230] Hazen (1992) *Law & Contemp Probs* 236.
[1231] Article 2(1) of the 1989 Directive.
[1232] Article 4 of the 1989 Directive.
[1233] Hazen (1992) *Law & Contemp Probs* 236.
[1234] Ibid.

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of information that they knew originated from a corporate insider and that they knew was inside information.[1235]

The inclusion in the definition of primary insider of persons possessing inside information through access by virtue of the exercise of their 'employment, profession *or duties*', lead Hopt to conclude that the clause netted all employees, regardless of whether their access was regular or occasional.[1236] The definition would include professional insiders such as accountants and attorneys and outsiders such as stock exchange employees, government officials, creditors and suppliers, union leaders, journalists and even legislators.[1237] To this had to be added the secondary insiders category, which would include anybody possessing inside information, as Warren remarks, 'from the primary insider's sister-in-law to a taxi driver'.[1238]

The European regulatory framework for regulating insider trading changed markedly in 2003.[1239] The directive (logically) dealt with market abuse in general.[1240] Illogically, however, it retained fiduciary and misappropriation aspects in its insider definition. The 2003 European Union Directive[1241] defined persons who fall foul of its insider dealing prohibition in Art 2. It provides that:

> 1. Member States shall prohibit any person referred to in the second subparagraph who possesses inside information from using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates.
>
> The first subparagraph shall apply to any person who possesses that information:

[1235] Ibid.

[1236] K J Hopt "The European Insider Dealing Directive" (1990) 27 *Common Mkt L Rev* 51 63–64.

[1237] Ibid. 63–64.

[1238] Warren (1991) *Washington and Lee Law Review* 1065.

[1239] *Langevoort on insider trading* (Rel 7 4/2009) 14-3.

[1240] For the formulation of the revising directives see J L Hansen "A New Proposal for a European Union Directive on Market Abuse" (2002) 23 *U Pa J Int'l Econ L* 241.

[1241] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation.

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(a) By virtue of his membership of the administrative, management or supervisory bodies of the issuer; or
(b) By virtue of his holding in the capital of the issuer; or
(c) By virtue of his having access to the information through the exercise of his employment, profession or duties; or
(d) By virtue of his criminal activities.

2. Where a person referred to in paragraph 1 is a legal person, the prohibition laid down in that paragraph shall also apply to the natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned.

The fiduciary and misappropriation theories are strongly entrenched in paragraphs 1(a), (b) and (c), with an interesting addition being found in paragraph (d). A person is also liable if he possesses the information by virtue of his criminal activities. It was perhaps a laudable addition as it at least recognised that there are persons to be held accountable for insider trading outside the categories based in the fiduciary and misappropriation theories. Here at least was a recognition that persons may be liable to sanction where they owe no fiduciary or quasi fiduciary duty to an issuer or other third party to the trade. However, it is still an addition, which is the result of the shortcomings of the two theories; it does not give effect to an independent theory with the ability to cover all trades perceived as wrong.

Fundamental to a new inclusion in its definition of insider, the 2014 European Regulations recognise expressly that the essential characteristic of insider dealing is that of an unfair advantage being obtained from inside information to the detriment of third parties who are unaware of such information.[1242] It recognises that the undermining of the integrity of financial markets and investor confidence lies in that characteristic.[1243] The European Parliament and the Council for the European Union decided that the question whether a person has infringed the prohibition on insider dealing or has attempted to commit insider dealing, should be analysed in the light of the purposes of this Regulation. That purpose is to protect the integrity

[1242] 2014 European Regulations, par. 23 of the preamble.
[1243] Ibid.

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of the financial markets and to have investor confidence, which is based, in turn, on the assurance that investors will be placed on an 'equal footing'.[1244] Therefore it was determined that the prohibition lies simply against 'a person who knows, or ought to have known, that the information constitutes inside information'.[1245] The Regulation further recognises that both legal persons and any natural person who participates in the decision-making of the legal person can be held liable for insider trading.[1246] Article 8 deals with 'insider dealing'. Article 8(4) provides as follows:

> 4. This Article applies to any person who possesses inside information as a result of:
>
> (a) being a member of the administrative, management or supervisory bodies of the issuer or emission allowance market participant;
> (b) having a holding in the capital of the issuer or emission allowance market participant;
> (c) having access to the information through the exercise of an employment, profession or duties; or
> (d) being involved in criminal activities.
>
> *This Article also applies to any person who possesses inside information under circumstances other than those referred to in the first subparagraph where that person knows or ought to know that it is inside information*. (Emphasis added.)

4 5 4 An incomplete paradigm shift

The Australian, New Zealand, and European Union legislatures have enacted definitions of insider, each of which takes a step toward the equal access theory. In Australia a person is an insider if he is in possession of inside information and he knows that he has inside information. There is no requirement of some sort of information connectedness for an insider. In the European Union's definition, much like in its South African counterpart, there are fiduciary and misappropriation categories of insider and a catchall category. The difference between the European Union's catchall and the South African tippee insider category lies in the fact that

[1244] Ibid. par. 24.
[1245] Ibid. par. 26.
[1246] Ibid. par. 40 and article 8(5).

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the South African version requires knowledge of the fact that the source of the information was a primary insider, whereas the European Union requires knowledge of the fact that the information is inside information. In New Zealand a person is an insider of a public issuer if he has inside information relating to that issuer. The knowledge requirement contained in the New Zealand definition, like that of the European Union, also requires the insider to know that he has inside information. These are steps in the right direction. The legislatures have, however, not completed the paradigm shift.

Broadly, the approach internationally has been to include within the definition of insider further persons or categories of persons as it was realised that a definition fails to cater for some traders who have access to inside information. Of this the United States is the supreme example. When the fiduciary doctrine was deemed insufficiently broad, the misappropriation theory was developed. As the two theories are insufficiently broad, tippee liability was developed. And as it was realised that there may still be insiders not covered with these three different bases of liability, special dispensations were created to address senators' trading with congressional information[1247] and in respect of mergers and acquisitions.[1248] With each added category, person or special dispensation, the question is always: so who then is left? Who then may trade with inside information?

Comprehensive and inclusive definitions of the term 'insider', like that of the Financial Markets Act, also inevitably lead to that question. The South African definition arguably contemplates a final category of traders who may freely trade with inside information.[1249] This category would be made up of those traders who knowingly have inside information, who are not primary insiders and who do not have knowledge of the information's source. It could also be argued that the primary insider category is couched in such broad terms that it would be

[1247] See above p. 251.

[1248] See above p. 247.

[1249] Cf Warren (1991) *Washington and Lee Law Review* 1065.

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never be possible for someone with inside information not to be included in the definition. If no group of traders exist who may trade with inside information, the definition has no role to play, but to leave the legislative scheme more complex. If such a group does exist, the legislative scheme does not pass the lowest test for legislation to pass constitutional muster:[1250] the legislative scheme would be unreasonable. As the culpability of insider trading in the financial markets lies in knowingly trading with inside information, leaving some market participants free to trade with inside information would amount to a legislative regime that does not treat equally culpable conduct equally. For the definition to pass constitutional muster, the distinction between those who may trade on inside information and those who may not must be reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom.[1251] There is no reason why the distinction is justifiable, no less so because one cannot even properly identify who may and who may not trade on inside information. In any event, as it has been argued,[1252] the only definition that would form the basis for a legislative regime that treats equally culpable conduct equally, would be the equal access to information theory.

The definition of insider should be removed from the regulatory scheme. As the Supreme of Western Australia has held, the term ‘insider’ has the potential to mislead.[1253] In my submission, in an equal access regime, it can serve only to mislead.

[1250] Cf *Ronald Bobroff & Partners Inc v De La Guerre* 2014 (3) SA 134 (CC) par. 7.
[1251] Section 36 of the Constitution.
[1252] See p. 127 above.
[1253] See p. 310 above.

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5 CONCLUSION AND A PROPOSAL

In 2006 Jooste wrote that the definitions of the terms 'insider' and 'inside information' in South African law are, while of vital importance, cumbersome, counter-intuitive and circular, leaving insider trading regulation fundamentally incoherent.[1254] The definitions of insider and inside information in the Financial Markets Act 19 of 2012 remain central to the regulation of insider trading, and Jooste's criticism still obtains.

The South African legislature has failed to undertake and act in accordance with the most fundamental enquiry in formulating a coherent regulatory scheme aimed at prohibiting supposedly wrongful conduct: identifying a single theory of wrongfulness upon which to base its prohibitions. Instead, the definitions evidence elements of all possible regulatory bases for insider trading, including those having as their object the protection of proprietary rights in information and born out of the fiduciary doctrine. The definitions remain rooted in company law theory, which requires them to include patchwork additions to regulate a financial market wrong. Patchwork additions do not make for a coherent regulatory scheme.

The legislature must formulate the definitions strictly in accordance with the rights and duties at play in the financial markets and the objectives with the regulation of those markets. Those objectives are the promotion of the fairness of and the public's confidence in the South African financial markets. The rights and obligations relevant to the inner-workings of companies or the ownership of information are, if at all, only tangentially relevant to the regulation of trading on inside information in the financial markets. The fundamental basis for the regulatory scheme must be the rights and obligations between participants in the financial markets inter se. The market theories of regulation recognise as much. There are two: the parity of information theory and the equal access to information theory. The regulatory scheme required

[1254] R Jooste (2006) 123 *S African LJ* 438. See p. 9 above, where the relevant portion of the article is quoted in full.

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by the parity information theory will be detrimental to market liquidity. The theory has as its object a practically unworkable egalitarian utopia. It would unreasonably restrict trade in securities.

The equal access theory is the regulatory basis best suited to the object of promoting confidence and fairness in the financial markets. The theory is reconcilable with Pothier's idea of affording traders just rewards and it fits well into the South African Constitutional legal landscape. The theory gives rise to definitions directly and coherently connected to the wrongfulness inherent in insider trading: that it is wrong for market participants to trade with information their fellow market participants cannot lawfully have access to.

It dictates that inside information has two characteristics. First, the information must not be lawfully accessible to the public. Second, on the information becoming so accessible, it must have an effect on the price of a security listed on a regulated market. The requirements, currently included in the definition, which go to the capacity in which and the means by which the information was learned, are to be removed. As to the 'non-public requirement', the 'not-lawfully accessible to all' requirement replaces it. There is no need to have an additional non-public requirement within the definition of inside information. The non-exhaustive list provided by the legislature of situations in which information would be non-public is also to be removed. In respect of the requirement going to the information's source, it is not be a requirement in and of itself. The fact that the information originated from a non-public source is merely one fact that goes to whether the information in question was accessible to the public at the time of the trade.

The current definition of inside information's requirements that go to the substantive characteristics of the information, merely serve to muddy the waters of what the enquiry in terms of the equal access theory should be. The requirement that the movement in the

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security's price must be material is superfluous. A requirement that there must be a movement in the security's price would suffice. That requirement, to my mind, performs the same function as the requirements that the information is to be specific and precise. The specificity and preciseness requirements just serve to confuse the enquiry. In any event, information that is imprecise and unspecific may in certain situations move market prices. The specificity and preciseness of the information may affect a market price, but they are not the only indicators to that effect. The price-sensitivity of information may be proved in a myriad ways. There is no reason, based in the equal access theory, why specificity and preciseness should be elevated to self-standing requirements. The specificity and preciseness requirements are to be removed from the definition. The word 'information' is, however, to be retained.

The definition of inside information should be amended to read as follows:

> 'inside information' means information that—
>
> (a) is not lawfully accessible to the public; and
> (b) on becoming so accessible would have an effect on the price or value of securities listed on a regulated market or of any derivative instrument related to such a security.

As to the definition of insider, there are various arguments made that some individuals and corporations should be allowed to trade on inside information. They fail to convince, especially when viewed in the context of the objects of the Act and the equal access to information theory. In my view, once inside information has been defined, the rule must be that no one should be allowed to deal with inside information. Accordingly, a definition of a group of people who are hit by the regulatory regime, is superfluous. The definition of insider is to be removed. This will be in accordance with the paradigm shift seen in various other jurisdictions, where the focus on trading by insiders has moved to trading on inside information.

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