

**THE NEW INSIDER TRADING PROVISIONS**

by

**MILES STUART SPEEDIE**

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**SUPERVISOR: PROFESSOR S.M. LUIZ**

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(i)

## SUMMARY

### **The New Insider Trading Provisions.**

It is unfair to the investing public and detrimental to the interests of the security markets for a person to trade on the basis of inside information. In this short dissertation, the laws regulating insider trading in South Africa prior to the current legislative provisions are briefly discussed. It is found that the old provisions were inadequate in deterring and punishing insider trading activities. The current legislative provisions are analysed in detail. It becomes clear that whilst the current provisions are a substantial improvement on their predecessor, certain aspects need to be reconsidered. These include the widening of their scope to include trading in all kinds of derivatives; the reformulation of the statutory civil action and the empowerment of the securities regulation panel to bring a civil action against insider traders.



**ABBREVIATIONS**

The following periodicals have been cited in abbreviated form as follows:

|                                   |   |
|-----------------------------------|---|
| <i>Can Bar R</i>                  | The Canadian Bar Review   |
| <i>Canterbury LR</i>              | Canterbury Law Review   |
| <i>J Bus L</i>                    | Journal of Business Law   |
| <i>SALJ</i>                       | South African Law Journal   |
| <i>SA Merc LJ</i>                 | SA Mercantile Law Journal   |
| <i>Sec LR</i>                     | Securities Law Review   |
| <i>Southwestern University LJ</i> | Southwestern University Law<br>Journal  |
| <i>THRHR</i>                      | Tydskrif vir Hedendaagse<br>Romeins-Hollandse Reg (Journal<br>of Contemporary Roman-Dutch<br>Law) |
| <i>TSAR</i>                       | Tydskrif vir die Suid-<br>Afrikaanse Reg (Journal of<br>South African Law)                        |
| <i>University of Toronto LJ</i>   | University of Toronto Law<br>Journal  |

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## 1. INTRODUCTION

Insider trading or dealing are terms used to describe the dealing in the securities of a company by any person, on the basis of information, which is not generally known to the reasonable investor in that security, and which information, if it became generally known to the reasonable investor in that security, would be likely to materially affect the price of that security, and where the person deals in the security on the basis of such information so as to make a profit or avoid a loss.<sup>1</sup>

Insider trading is a form of white-collar crime<sup>2</sup> and is characterised by the failure of the person trading on the basis of inside information to disclose the inside information to the other party to the transaction.<sup>3</sup> Insider trading cases do not involve a positive misrepresentation by the insider. They simply involve complete silence on the part of the insider.<sup>4</sup>

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<sup>1</sup> See Van Zyl "Die bekamping van binnekennistransaksies in Suid-Afrika" (1989) 1 *TSAR* 77 at 77. Boyle and Sykes (eds) *Gore-Browne on Companies* (1986) vol 1 state at 12.017-12.018: "Insider dealing in corporate securities involves the deliberate exploitation of unpublished price-sensitive information, obtained through a privileged relationship, to make a profit or avoid a loss by dealing in the securities the price of which would be materially altered by public disclosure of that information."

<sup>2</sup> Botha "Control of Insider Trading in South Africa: A Comparative Analysis" (1991) 3 *SA Merc LJ* 1 at 2-3. See also Edelhertz "The Nature, Impact, and Prosecution of White Collar Crime" in Johnson and Douglas (eds) *Crime at the Top: Deviance in Business and the Professions* (1978) at 44 where white-collar crime has been defined as "... illegal acts committed by non-physical means and by concealment or guile, to obtain money or property, to avoid the payment or loss of money or property, or to obtain business or personal advantage."

<sup>3</sup> The word "insider" will be used to describe the person trading on the basis of inside information, and the word "outsider" will be used to describe the other party to the transaction.

<sup>4</sup> Branson "American Business Law Insider Trading - I The British Regulation in the Light of the American Experience" 1982 *J Bus L* 342 at 342-343.

Whilst it is not universally agreed that insider trading is reprehensible<sup>5</sup>, most countries consider insider trading to be improper and that it should be regulated. This is normally based on arguments grounded in notions of fairness, market efficiency and market integrity.<sup>6</sup> From the perspective of the investor, insider trading is unfair mainly because it is considered only fair that all investors should have equal access to the same information.<sup>7</sup> It is accepted for the purposes of this dissertation that insider trading should be regulated.<sup>8</sup>

The current South African legislation regulating insider trading (the new provisions) is contained in Chapter XVA of the Companies Act 61 of 1973 (the Companies Act). The new provisions prohibit trading on the basis of inside information<sup>9</sup> (insider trading) and make provision for criminal and civil

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<sup>5</sup> Hannigan *Insider Dealing* (1988) at 6.

<sup>6</sup> See Bennetts "Regulation of Insider Trading: The Australian Experience" (1987) 3 *Canterbury LR* 254 at 255-256; Botha op cit note 2 at 3-4; Hannigan op cit note 5 at 6-15 and Suter *The Regulation of Insider Dealing in Britain* (1989) at 14-49. A minority of writers believe that insider trading should not be regulated. See for example, Manne *Insider Trading and the Stock Market* (1966).

<sup>7</sup> Van Zyl op cit note 1 at 77. For an analysis of the effects of insider trading on companies, the capitalist system and management, see Leigh Ffrench and Rider "Should Insider Trading be Regulated? Some Initial Considerations" (1978) 95 *SALJ* 79 at 86-101. In *Attorney-Generals Reference* (No 1 of 1988) [1989] 1 All ER 321 at 325, Lord Lane of the Court of Appeal described the rationale behind the prohibition of insider trading in terms of the Company Securities (Insider Dealing) Act 1985 (the IDA) of the United Kingdom as "the obvious and understandable concern ... about the damage to public confidence which insider dealing is likely to cause and the clear intention to prevent so far as possible what amounts to cheating when those with inside knowledge use that knowledge to make a profit in their dealing with others."

<sup>8</sup> Although there is very little concrete evidence in this regard, it can be accepted that insider trading is common in South Africa: Botha op cit note 2 at 1.

<sup>9</sup> Section 440F(1) of the Companies Act. See Luiz "Prohibition Against Trading on Inside Information - The Saga Continues" (1990) 2 *SA Merc LJ* 328 at 330.

liability<sup>10</sup> for trading on the basis of inside information. Certain rebuttable presumptions are created, where certain facts are proved, that will assist the state in proving the elements of the crime of insider trading.<sup>11</sup> A severe criminal penalty can be imposed on persons found guilty of insider trading.<sup>12</sup>

A body corporate known as the Securities Regulation Panel (the panel) has been created and charged with the functions, inter alia, of investigating and controlling insider trading.<sup>13</sup> To enable the panel to effectively perform its functions, it has been granted the power to subpoena and interrogate persons.<sup>14</sup> Further, the panel has the power to impose an obligation on certain persons who, as a result of their position in a company or as a result of their shareholding in a company, are in a position to obtain inside information regarding the securities of that company, to disclose to the panel the extent of their beneficial holdings in that company and any change therein.<sup>15</sup> In this way the dealing in securities by certain persons who are likely to obtain inside information regarding the securities of a company can be monitored easily.

Provision is made for the exemption by the Minister<sup>16</sup> of any class of persons from the provisions creating civil and criminal liability for insider trading.<sup>17</sup> The new provisions

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<sup>10</sup> Section 440F(1) and section 440F(4) of the Companies Act.

<sup>11</sup> Section 440F(3) of the Companies Act.

<sup>12</sup> Section 441(1)(a) of the Companies Act.

<sup>13</sup> Section 440C(1)(b) of the Companies Act.

<sup>14</sup> Section 440D(1) of the Companies Act.

<sup>15</sup> Section 440G of the Companies Act.

<sup>16</sup> Minister of Industries, Commerce and Tourism.

<sup>17</sup> Section 440F(6) of the Companies Act.



do not apply to dealings in members' interests in a close corporation.<sup>18</sup>

The objective of this short dissertation is to evaluate the law regulating insider dealing in South Africa in the light of the new provisions. Certain shortcomings in the new provisions will be identified and reforms to improve its effectiveness in deterring insider trading and compensating victims thereof, will be proposed. Prefatory to a detailed analysis of the new provisions, the remedies available to an outsider in terms of the common law and the statutory derivative action will be considered. Further, a brief overview of the predecessor to the new provisions will be offered.

## 2. THE COMMON LAW

### 2.1 General

In South Africa, prior to 1973, there was no legislation regulating insider trading and thus outsiders were forced to seek recourse in the common law.<sup>19</sup> The protection afforded to an outsider in terms of the common law is limited.<sup>20</sup>

In terms of the common law the outsider, in order to succeed in an action against the insider, must prove that the failure by the insider to disclose the inside information constituted a form of misrepresentation. Thus the outsider must establish that there was a duty on the insider to disclose the inside information. However, in our law, there is no general duty on a person who possesses information unknown to the other party to disclose such information to the other party, even where he

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<sup>18</sup> Section 440F(5) of the Companies Act.

<sup>19</sup> Botha op cit note 2 at 4.

<sup>20</sup> See Jooste "Insider Dealing in South Africa" (1990) 107 SALJ 588 at 600-602 and Van Zyl op cit note 1 at 85-88.

knows it may influence the other party in deciding whether to conclude the contract.<sup>21</sup> The duty to disclose such information does arise in certain exceptional circumstances.<sup>22</sup> Where these circumstances exist then the general principles regarding misrepresentation would be applicable.

The duty would arise where there is a duty of good faith between the parties. Such a duty would, for example exist between partners or where a fiduciary relationship exists between parties<sup>23</sup>. Millner suggests that the duty arises where there is an

"involuntary reliance of the one party on the frank disclosure of certain facts necessarily lying within the exclusive knowledge of the other such that, in fair dealing, the former's right to have such information communicated to him would be mutually recognised by honest men in the circumstances."<sup>24</sup>

He states:

"It is the contemplation of reasonable men that is primary. Thus a party who neither looks to the other party for information nor expects it cannot properly complain of the other's silence. Stock exchange transactions are a clear instance of this. Such bargains have a pronounced speculative character well recognised by both buyer and seller and heightened by the anonymity of the principals and the complete absence of preliminary negotiations. There is a common understanding in such cases that each is content to trust exclusively to his own judgment about the shares dealt in, no matter how unequal the knowledge of the parties may in fact be. But it does not automatically follow that the sale of the identical shares between parties negotiating privately, and face to face, is subject to the same understanding, and the origin and character of their

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<sup>21</sup> *Speight v Glass and another* 1961 (1) SA 778 (D) at 781 and *Hoffman v Moni's Wineries Ltd* 1948 (2) SA 163 (C) at 168.

<sup>22</sup> Jooste op cit note 20 at 601.

<sup>23</sup> Ibid.

<sup>24</sup> Millner "Fraudulent Non-disclosure" (1957) 74 SALJ 177 at 189.

negotiations may very well suggest that relationship of involuntary dependence or trust which is or ought to be recognised by both parties as requiring the disclosure of a particular matter of which the one knows the other to be ignorant".<sup>25</sup>

In *Pretorius and another v Natal South Sea Investment Trust Ltd (Under Judicial Management)*<sup>26</sup> the court approved of Millner's approach in regard to face-to-face share transactions. The court held that there was a duty on the directors of the company to disclose the existence of a particular contractual obligation of the company to the applicants for shares in the company.<sup>27</sup>

On the basis of Millner's formulation and the *Pretorius* case, it appears that our common law only recognises the duty to disclose in respect of face-to-face share transactions but not non-face-to-face share transactions<sup>28</sup>.

The remedies available to an outsider in a contractual action would be restitution and damages, and simply damages in a delictual action.<sup>29</sup>

Since brokers on the Johannesburg Stock Exchange (the JSE)

"operate a 'clearing house' for traded securities and deliver only differences in balance to each house, it is generally extremely difficult if not impossible to link a buyer with a particular seller or to link shares delivered with a particular sale."<sup>30</sup>

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<sup>25</sup> *Idem* at 190.

<sup>26</sup> 1965 (3) SA 410 (W) at 418.

<sup>27</sup> *Ibid.*

<sup>28</sup> Jooste *op cit* note 20 at 602.

<sup>29</sup> Van Zyl *op cit* note 1 at 86.

<sup>30</sup> Rider "Regulation of Insider Trading in the Republic of South Africa" (1977) 94 SALJ 437 at 439.

Thus even if Millner's formulation is incorrect and our law recognises a duty to disclose in respect of non-face-to-face stock exchange share transactions, the outsider is faced with the nearly impossible task of identifying the insider.

## 2.2 Directors

Our courts have not pronounced on the question whether a director owes a fiduciary duty to the shareholders of the company of which he is director<sup>31</sup>. When they do " there appears to be no reason why they should deviate from the English view."<sup>32</sup> *Percival v Wright* is regarded as having established the principle in English law that a director does not owe a fiduciary duty to the shareholders of his company.<sup>33</sup> This case concerned directors who acquired shares from a shareholder when the directors were in possession of confidential information about the company which would impact on the price of those shares. Swinfen Eady J stated:

"I am ... of the opinion that the purchasing directors were under no obligation to disclose to their vendor shareholders the negotiations which ultimately proved abortive. The contrary view would place directors in a most invidious position, as they could not buy or sell shares without disclosing negotiations, a premature disclosure of which might well be against the best interests of the company."<sup>34</sup>

This principle was qualified in New Zealand in the decision of *Coleman v Meyers* where it was held that in a private family-held company the situation could be such as to establish a

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<sup>31</sup> Jooste op cit note 20 at 601.

<sup>32</sup> Ibid.

<sup>33</sup> [1902] 2 Ch 421.

<sup>34</sup> Idem at 426.

fiduciary duty between the directors and the shareholders.<sup>35</sup> It is further possible, that for example in a takeover situation, the directors may place themselves in the position of acting as agents for the shareholders and thus, despite *Percival v Wright*, owe fiduciary duties to the shareholders.<sup>36</sup> If the directors then persuaded a shareholder to sell the shares to them at a price which they knew was materially lower than the price the bidder was prepared to pay and the shareholder was ignorant of this, then the directors would be breaching this duty.<sup>37</sup>

A director does however, owe a fiduciary duty to his company.<sup>38</sup> Thus a director may not, without the informed consent of the company use, for his own purpose, the company's assets, opportunities or information.<sup>39</sup> Thus it is arguable that a director is accountable to his company for secret profits made through insider trading.<sup>40</sup>

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<sup>35</sup> [1977] 2 NZLR 225. For a further example of a departure from the *Percival v Wright* doctrine see *Strong v Repide* 213 U.S. 419 (1909) at 430-435.

<sup>36</sup> Gower *Gower's Principles Of Modern Company Law* (1992) at 608. See also Van Zyl op cit note 1 at 86.

<sup>37</sup> Gower op cit note 36 at 608.

<sup>38</sup> Meskin (ed) *Henochsberg on the Companies Act* (1985) at 388. See further *Robinson v Randfontein Estates Gold Mining Company Limited* 1921 AD 168 at 179-180 and *Novick v Comair Holdings Limited and others* 1979 (2) SA 116 (W) at 151-155.

<sup>39</sup> Gower op cit note 36 at 564. See further *Atlas Organic Fertilisers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA 173 (T) at 196-199 and *Bellairs v Hodnett* 1978 (1) SA 1109 (A) at 1126-1134.

<sup>40</sup> See Henochsberg op cit note 38 at 391-392. In the United States, corporate fiduciaries who use inside information may, at common law, be held liable to account to the company for the gain made or loss avoided: *Diamond v Oreamuno* 24 N.Y. 2d 494, 248 N.E. 2d 910 (1969) at 912-916. The recovery by the company will not help the outsider unless he remains a shareholder of the company and unless the sum recovered is sufficient to cause an appreciation in the value of the shares in the company in question. The director however, will be deprived of his gains.

It is thus apparent that in terms of the common law an outsider has a cause of action against an insider in certain limited circumstances. In addition, the outsider can receive indirect compensation where the company recovers the insider gains of a director. However, the likelihood of such an action being instituted is remote since it is unlikely that a company would institute action against a director. Whilst the outsider can institute the company's action in a common law derivative action, it is unlikely that the outsider would do so since, should he succeed, the benefits he would receive would generally be small whereas should he fail, the legal costs would be large.<sup>41</sup>

It would seem that as at the enactment of section 233 of the Companies Act, the common law had not developed to the extent where it constituted a meaningful deterrent to insider trading or an adequate remedy providing compensation for the victims of insider trading.

### **3. THE STATUTORY DERIVATIVE ACTION**

The question arises whether the statutory derivative action in terms of section 266 of the Companies Act provides outsiders<sup>42</sup> with a remedy against directors or officers of a company who trade in the securities of that company on the basis of inside information. For section 266 to be applicable, the use of inside information by a director or officer<sup>43</sup> of a company must constitute a wrong, breach of faith or breach of trust by the director or officer concerned.<sup>44</sup> In addition the company must

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<sup>41</sup> See Van Zyl op cit note 1 at 88.

<sup>42</sup> The outsider must be a member of the company before section 266 becomes available to the outsider: Section 266(1) of the Companies Act.

<sup>43</sup> As defined in section 1 of the Companies Act.

<sup>44</sup> Section 266(1) of the Companies Act.

as a result thereof have suffered damages or loss or been deprived of a benefit.<sup>45</sup> Under what circumstances would a company suffer damages or loss or be deprived of a benefit where a director or officer of the company deals in the securities of the company on the basis of inside information? Where the insider dealing by the director or officer affects the price of the securities of the company with the result that the company's ability to raise capital in the market is prejudiced or the company's position in a take-over bid is prejudiced, it is arguable that the company suffered damages or loss or was deprived of a benefit.<sup>46</sup> However, since the price of a company's securities is influenced by many factors, it seems unlikely that an outsider would be able to establish that it was the dealing by the director or officer that caused the movement in the price of the company's securities and thus the damage or loss or deprivation of a benefit suffered by the company.<sup>47</sup> It is thus felt that it is unlikely that section 266 of the Companies Act provides any assistance to outsiders.

#### 4. THE OLD STATUTORY PROVISIONS

Section 233<sup>48</sup> of the Companies Act read with sections 224<sup>49</sup>,

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<sup>45</sup> Ibid.

<sup>46</sup> Van Zyl op cit note 1 at 84.

<sup>47</sup> Ibid.

<sup>48</sup> See the Main Report of the Commission of Enquiry into the Companies Act (the Van Wyk de Vries Report) RP 45(1970). The recommendations of the Commission regarding insider trading resulted in the enactment of section 229 and section 233.

<sup>49</sup> Section 224, inter alia, prohibited directors from dealing in options in respect of listed shares and debentures of the company or its subsidiary or holding company or a subsidiary of its holding company.

229<sup>50</sup>, 230<sup>51</sup>, 231<sup>52</sup>, 232<sup>53</sup>, and 441<sup>54</sup> was the first attempt to control insider trading in South Africa.<sup>55</sup>

Section 233 provided that:

"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 on a stock exchange or in a newspaper or through the medium of the radio or television, shall be guilty of an offence."

The JSE, the Registrar of Companies and the Department of Justice were responsible for the enforcement of the criminal sanctions for insider trading contained in section 233. The

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<sup>50</sup> Section 229 defined interest, officer, past director, person, shares and debentures of the company for the purposes of sections 230, 231, 232 and 233 of the Companies Act.

<sup>51</sup> Section 230, inter alia, obliged every public company having a share capital to keep a register of interests of directors and others in shares and debentures of the company.

<sup>52</sup> Section 231, inter alia, required the directors of a company when they have knowledge of inside information relating to the company to determine by resolution of the company which officers of the company, whose names had not already been entered in the register under section 230, are to be taken as possessed of the inside information during the course of their respective duties and to cause their names to be entered into the register.

<sup>53</sup> Section 232, inter alia, obliged directors, past directors, officers and certain persons to lodge with a company within a specified period written notice regarding changes in any material interest in their shareholding in the company concerned.

<sup>54</sup> Section 441(1)(b) provided that the criminal penalties for contravening Section 233 was a maximum fine of R8 000,00 or two years imprisonment, or both such fine and imprisonment.

<sup>55</sup> Section 224 and sections 229 - 233 were repealed by section 6 of the Companies Amendment Act 78 of 1989 with effect from 1 February 1991 in terms of Government Notice R10 *Government Gazette* 12997 of 1 February 1991 (*Reg. Gaz.* 4646).



JSE's function was the detection of insider trading by the monitoring of trading. It had the power to request the dealing returns from brokers when insider trading was suspected. The JSE would submit the returns to the Registrar of Companies who was responsible for the further investigation of the matter. Finally the evidence would be handed to the Attorney General who would decide whether or not to prosecute the matter.<sup>56</sup>

Section 233 was completely ineffective and did not result in any prosecutions.<sup>57</sup> It failed to make provision for the lapse of a reasonable period after the public announcement of information. Thus insiders could deal immediately after the publication of price-sensitive information and before the share prices reflected the information. In this way, insiders could circumvent section 233.<sup>58</sup> The price-sensitive information covered by section 233 had to relate to "a transaction or proposed transaction of the company or of the affairs of the company". It thus did not cover information about the market for a company's securities.<sup>59</sup> Only a limited category of persons were insiders for the purposes of section 233.<sup>60</sup> For example, it did not include within its ambit the activities of secondary insider traders, eg. tippees.<sup>61</sup>

Rider stated in regard to section 233 that: "It is not perhaps uncharitable to describe the South African statutory provisions as an unholy jumble or even a statutory mess."<sup>62</sup>

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<sup>56</sup> Botha op cit note 2 at 5.

<sup>57</sup> Ibid. For a critique of section 233 see Rider op cit note 30 at 442-448 and Van Zyl op cit note 1 at 77-84.

<sup>58</sup> Jooste op cit note 20 at 593-594.

<sup>59</sup> Idem at 594.

<sup>60</sup> Van Zyl op cit note 1 at 77-79.

<sup>61</sup> Jooste op cit note 20 at 595.

<sup>62</sup> Rider op cit note 30 at 445. The criminalisation of insider trading in terms of section 233 meant that insider trading was wrongful at civil law. Thus section 233 enabled the outsider to bring a delictual action

## 5. THE NEW PROVISIONS

### 5.1 Source of the New Provisions

The new provisions regulating insider trading were contained in the Companies Amendment Act 78 of 1989 and the Companies Second Amendment Act 69 of 1990.<sup>63</sup>

Section 440F of the 1989 Amendment Act never came into operation and was replaced by a new section 440F in terms of section 3 of the 1990 Amendment Act. Section 440F<sup>64</sup> of the 1989

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against the insider for damages suffered as a result of the insider's insider trading: Jooste op cit note 20 at 602. However, it would still have been necessary to establish privity which would only have been possible in face-to-face share transactions.

<sup>63</sup> Section 4(a) of the 1989 Amendment Act inserted Chapter XVA titled "Regulation of Securities" into the Companies Act. Section 4(b) of the 1989 Amendment Act inserted, inter alia, the new provisions being sections 440A, 440B, 440C, 440D, 440E, 440F and 440G into the Companies Act. The new provisions form part of Chapter XVA. Section 440B was put into operation with effect from 1 October 1989 in terms of Government Notice R170 in *Government Gazette* 12112 of 29 September 1989 (*Reg. Gaz.* 4414). Sections 440A, 440C, 440D and 440E were put into operation with effect from 26 January 1990 in terms of Government Notice R11 in *Government Gazette* 12265 of 26 January 1990 (*Reg. Gaz.* 4448). Section 440C was amended by the 1990 Amendment Act.

<sup>64</sup> Section 440F of the 1989 Amendment Act provided that:

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

- (a) employs any device, scheme or artifice to defraud any person;
- (b) makes any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
- (c) engages in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

shall be guilty of an offence.

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

- (a) any director, past director or officer of a company or any person connected with a company having knowledge of any information likely, when published, to affect the price of

Amendment Act was based on American legislation, namely rule 10b-5 promulgated by the Securities Exchange Commission and section 10(b) of the Securities Exchange Act of 1934 (the Securities Exchange Act). It was subject to substantial criticism. Botha wrote that sections 440F(1) and (2) of the 1989 Amendment Act "again failed to provide an operational definition of an insider trader and insider information."<sup>65</sup>

Luiz commented:

"Although the interpretations of the American courts may well have produced considerable certainty in American law, our courts are obliged to interpret any legislation enacted by the South African legislature in accordance with established South African legal principles, and it is thus doubtful whether the same certainty would prevail here. For example, the memorandum itself recognised that the concept 'fraud' in the United States differs from ours. It is axiomatic that problems of interpretation lurk in the background when foreign legislation is adopted piecemeal into any municipal system of law."<sup>66</sup>

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securities of that company, dealing, except for the proper performance of the functions attaching to his position with that company, in such securities before the expiration of a period of not less than 24 hours after such information has been publicly announced for the first time on a stock exchange or in a newspaper or through the medium of the radio or television or by any other means;

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

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

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

<sup>65</sup> Botha op cit note 2 at 9.

<sup>66</sup> Luiz op cit note 9 at 328-329.

Section 3 of the 1990 Amendment Act was an attempt to remedy the defects of the 1989 Amendment Act.<sup>67</sup> A statement from the Memorandum on the Objects of the Companies Second Amendment Bill 1990 said:

"The present provisions of section 440F of the Act, which place a prohibition on insider trading, were derived from the equivalent provisions in the United States of America, mainly because interpretations by courts over the past few years have given a high degree of certainty to the legislation. Although section 440F has not yet been put into operation, the perception, and indeed the fear, have arisen on the part of some South African financial institutions that the net has been cast too wide and that certain important, innocent investment activities are included in the prohibition. This perception is largely based on the fear that South African common law concepts of fraud differ from those in the United States of America, and that those differences will result in South African courts giving an interpretation which will widen the prohibition. The proposed amendments are aimed at clarifying the scope of the prohibition."<sup>68</sup>

## **5.2 The Panel**

### **5.2.1 The Establishment of the Panel**

Section 440B of the Companies Act established a body corporate to be known as the Securities Regulation Panel<sup>69</sup> and provides that its members shall be appointed by the Minister<sup>70</sup> of Industries, Commerce and Tourism.

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<sup>67</sup> Section 440F came into operation on 1 February 1991 in terms of Government Notice R11 *Government Gazette* 12997 of 1 February 1991 (*Reg. Gaz.* 4646).

<sup>68</sup> [B 119 - 90 (GA)] at 17.

<sup>69</sup> Section 440B(1) of the Companies Act.

<sup>70</sup> Section 440B(2) of the Companies Act.

The members of the panel consist of the chairman<sup>71</sup>, the Registrar, the chairman of the Competition Board<sup>72</sup>, such persons nominated by the organisations specified in section 440B(3)<sup>73</sup>, and any other persons co-opted by the panel as additional members in terms of section 440B(6).<sup>74</sup> Every member holds office for a period of five years<sup>75</sup> provided that the

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<sup>71</sup> The chairman need not be one of the nominated members and is designated by those members who were nominated by the organisations referred to in section 440B(3): section 440B(4) of the Companies Act. The panel may designate a member of the panel to act as acting chairman, to exercise and perform the powers and duties of the chairman whenever the chairman is unable to do so or while the office of the chairman is vacant: section 440B(5) of the Companies Act. The chairman decides the time and place of the meetings of the panel: section 440B(10)(a) of the Companies Act. The procedures at such meetings are determined by the person presiding at such meeting: section 440B(10)(b) of the Companies Act. The decision of the majority of the members of the panel present at any meeting at which there is a quorum constitute the decision of the panel: section 440B(10)(c) of the Companies Act. Where there is an equality of votes the chairman has a casting vote in addition to his deliberative vote: section 440(10)(c) of the Companies Act. No proceedings of the panel are invalid by reason only of the fact that a vacancy existed on the panel and that any member was not present during the proceedings or any part thereof: section 440B(10)(d) of the Companies Act. The panel shall appoint an executive director to hold office for a period and on the conditions determined by the panel: section 440B(11) of the Companies Act. In addition, the panel shall have an executive committee which consists of the executive director and so many members of the panel as the panel may determine, one of whom may be the chairman of the panel: section 440B(12) of the Companies Act.

<sup>72</sup> The Competition Board was established by section 3 of the Maintenance and Promotion of Competition Act 96 of 1979.

<sup>73</sup> The bodies are: the Johannesburg Stock Exchange, the South African Federated Chamber of Industries, the Association of Chambers of Commerce and Industry of South Africa, the Afrikaanse Handelsinstituut, the Association of General Banks, the Clearing Bankers Association of South Africa, the Merchant Bankers' Association, the Shareholders' Association of South Africa, the Pensions Institute (of Southern Africa), the Chamber of Mines of South Africa, the Life Offices' Association of South Africa, the South African Institute of Chartered Accountants, and the Association of Law Societies of the Republic of South Africa.

<sup>74</sup> Section 440B(3) provides that the organisations listed in section 440B(3) shall be entitled to nominate one person, and in the case of the JSE three persons, to serve on the panel.

<sup>75</sup> If, during any such five year period, a member of the panel nominated pursuant to the provisions of section 440B(3) dies, becomes incapacitated, resigns, or becomes disqualified from being appointed or acting as a director of a company in terms of section 218 of the Companies Act, or ceases for any other reason to be a member of the panel, the

said organisations may apply to the Minister to have their nominated members replaced by any other nominee before the expiry of the member's term of office.<sup>76</sup>

The panel can appoint such officers and employees as are necessary for the proper functioning of the panel.<sup>77</sup> The panel can delegate any of its powers to the executive committee or to any sub-committee of the panel which may have been established by the panel.<sup>78</sup>

### 5.2.2 The Functions of the Panel

#### 5.2.2.1 Investigation by the Panel

The Memorandum on the Objects of the Companies Amendment Bill 1989 stated in respect of the panel:

"A further function of the panel will be to exercise control over insider trading.<sup>79</sup> This Bill aims at eliminating the deficiencies which exist in this regard in respect of the present provisions in the Companies Act, 1973. The panel will have power to investigate cases of suspected insider trading. In this regard the panel will be a proper forum where

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vacancy so arising may be filled for the unexpired portion of such member's term of office by a nominee of the organisation who nominated such member: section 440B(8) of the Companies Act. Members on expiry of their term of office are eligible for reappointment: section 440B(9) of the Companies Act.

<sup>76</sup> Section 440B(7) of the Companies Act.

<sup>77</sup> Section 440B(13) of the Companies Act.

<sup>78</sup> Section 440B(14) of the Companies Act.

<sup>79</sup> Section 440C(1)(b) provides that one of the functions of the panel is to supervise the dealings in securities that are contemplated in terms of Chapter XVA. Section 440C(6)(c) provides that the panel or its executive committee or its executive director may receive and deal with representations relating to any matter with which it may deal in terms of Chapter XVA. Section 440C(6)(d) provides that the panel or its executive committee or its executive director may perform any other functions assigned to it in Chapter XVA.

complaints regarding insider trading can be lodged."<sup>80</sup>

The role played by the panel is fundamental to the success of the new provisions. Insider trading activities must be detected and properly investigated so as to facilitate the successful prosecution of offenders. It is improbable that, without the existence of the panel with its powers of interrogation and subpoena<sup>81</sup> and its powers in terms of section 440G, the new

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<sup>80</sup> [B99-89 (GA)] at 20.

<sup>81</sup> Section 440D(1) empowers the panel or any committee thereof for the purpose of fulfilling its functions in terms of Chapter XVA to -

- (a) summon any person who is believed to be able to furnish any information on the subject of an investigation or to have in his possession or under his control any book, document or other object which has any bearing on that subject, to appear before the panel or the committee at the time and place specified in the summons, to be interrogated or to produce such book, document or other object; and
- (b) to interrogate any such person under oath or affirmation administered by the chairman or a person appointed by him, and to examine or retain for examination such book, document or other object.

Section 440D(2) provides that such summons shall be in the form prescribed by the panel and shall be signed by the chairman of the panel or committee and that it shall be served in the manner so prescribed.

Section 440D(3) provides that any person who has been summoned to attend before, or to produce any book, document or other object to the panel or a committee thereof, and who, without sufficient cause (the onus of proof of which shall rest on him), fails to attend at the time and place specified in the summons or who fails to remain in attendance until excused by the chairman thereof, or, having attended, refuses to be sworn or make an affirmation after he has been asked by the chairman (or a person appointed by him) to do so, or who, having been sworn or having made affirmation, fails to fully and satisfactorily answer any question lawfully put to him, or who fails to produce any book, document or other object in his possession or under his control which he has been summoned to produce, shall be guilty of an offence.

Section 440D(4) provides that any person who, after having been sworn or having made affirmation, gives false evidence before the panel or a committee thereof knowing such evidence to be false or who does not believe the evidence is true, shall be guilty of an offence.

provisions will be any more effective in deterring insider trading than the old provisions.<sup>82</sup>

#### 5.2.2.2 Disclosure to the Panel

Section 440G(1)<sup>83</sup> provides the panel with authority to require

"by notice in the *Gazette* that every person who is or becomes directly or indirectly the beneficial owner<sup>84</sup> of more than 10 per cent, or such other percentage as may be prescribed by the panel by notice in the *Gazette*, of any class of any equity security (other than a security exempted in terms of the rules) which is dealt with on a stock exchange, or who is a director or an officer of the issuer of such security, lodge, at the time of the listing of such security on a stock exchange, or within 10 days after he or it becomes such beneficial owner, director or officer, a statement with the panel of the amount of all equity securities of such issuer of which he or it is the beneficial owner, and within 10 days after the close of each calendar

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Section 440D(5) provides that the law relating to privilege as applicable to a witness giving evidence before, or summoned to produce a book, document or other object to, a provincial division of the Supreme Court of South Africa shall apply in relation to any person summoned under section 440D.

Section 440D(6) provides that nothing contained in Chapter XVA of the Companies Act shall be deemed to compel the production by a legal advisor of a letter, report or other document containing a privileged communication made by or to him as legal adviser, or to authorise the seizure or retention thereof.

<sup>82</sup> See Jooste op cit note 20 at 589.

<sup>83</sup> Section 440G was introduced by the 1989 Companies Amendment Act and was amended by the 1990 Companies Second Amendment Act. Section 440G was put into operation with effect from 1 February 1991 in terms of Government Notice R10 in *Government Gazette* 12997 of 1 February 1991 (*Reg. Gaz.* 4646). Section 440G(1) is almost identical to section 16(a) of the Securities Exchange Act.

<sup>84</sup> A person would directly be the beneficial owner where the equity security is registered in his name or the name of a nominee. It is suggested that a person would be regarded as indirectly the beneficial owner where, inter alia, the securities are held in the name of another person if by some agreement or arrangement he acquires benefits which are similar to those of ownership; or all the securities are held by a company which he controls: see *Loss Fundamentals of Securities Regulation* (1988) at 569-574.



month thereafter, if there has been any change<sup>85</sup>, in such manner as may be determined by the panel by notice in the Gazette, in such ownership during such month, file with the panel a statement indicating such change in his or its ownership as has occurred during the calendar month."

Section 440G(2) provides that any person who fails to comply with any provision of section 440G(1) shall be guilty of an offence. The penalty is a fine not exceeding R20 000,00 or imprisonment not exceeding five years or both.<sup>86</sup>

The purpose of section 440G is to assist in the determination of the identity of insiders in respect of stock exchange share transactions<sup>87</sup>. It is focused on those persons who are more likely than any other to acquire unpublished price-sensitive information in respect of a security and thus be in a position to trade on the basis thereof, namely those persons who are in a position of power within a company and those persons who have power over a company as a result of their shareholding in the company.<sup>88</sup> By requiring such persons to file a statement with the panel of all equity securities of which they are the beneficial owner and within ten days after the close of each calendar month a statement of any change therein, the panel will be able to relate the time period during which such person traded to the time which such person had unpublished price-sensitive information in his possession<sup>89</sup>. In this way, section

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<sup>85</sup> Any change in beneficial ownership must be reported whether it results from a purchase or a sale or any other event.

<sup>86</sup> Section 441(1)(c) of the Companies Act.

<sup>87</sup> The regulation of insider trading will only be effective when insiders believe that there is a reasonable chance of detection. Where the transaction is face-to-face involving unquoted securities then the outsider will easily be able to detect the insider with whom he dealt. The problem of detection exists mainly in stock exchange transactions because the anonymity of the system will generally allow the insider to avoid detection. This is because existing stock exchange and broking procedures do not facilitate the identification of the parties to the transaction.

<sup>88</sup> Jooste op cit note 20 at 599.

<sup>89</sup> Ibid.

440G facilitates the easy detection of insider trading by such persons.

It is fundamental to the success of the new provisions that the reporting requirements of section 440G are strictly enforced.<sup>90</sup> If it is realised that the failure to comply with the provisions of section 440G is not likely to be detected, there will be a great incentive for persons not to disclose. Further, if the criminal provisions of section 440G(2) are not readily enforced, then the system of deterrence through disclosure created in section 440G(1) will fail.<sup>91</sup>

Section 16(b) of the Securities Exchange Act enables a company to recover profits made by persons referred to in section 16(a) of that Act from the sale and purchase, or purchase and then sale, of equity in their company within a period of six months.<sup>92</sup> It thus provides for the recovery of short swing profits from those persons required to file insider reports under section 16(a).<sup>93</sup> The purpose of the section is to prevent the unfair use of information by such persons which information they may have obtained by reason of their relationship to the issuer.<sup>94</sup> Since the equivalent of section 16(a) was enacted in section 440G, the question arises why the equivalent of section 16(b) was not enacted and whether it should have been.<sup>95</sup>

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<sup>90</sup> See Bennetts op cit note 6 at 276.

<sup>91</sup> Ibid.

<sup>92</sup> Loss op cit note 84 at 542-543.

<sup>93</sup> See Davies "Canadian and American Attitudes on Insider Trading" (1975) 25 *University of Toronto LJ* 215 at 224.

<sup>94</sup> Loss op cit note 84 at 542.

<sup>95</sup> For a discussion on section 16(b), see Luiz "Insider Trading: A Transplant to Cure a Chronic Illness" (1990) 2 *SA Merc LJ* 59 at 66 and Davies op cit note 93 at 224-229.

Section 16(b) has been criticised for punishing the persons referred to in section 16(a) for simply dealing in securities and not because they were dealing in the securities on the basis of inside information.<sup>96</sup> The effect of section 16(b) is that liability arises irrespective of the person's knowledge or intention.<sup>97</sup> The liability arises automatically because the person happened to trade in the company's securities during the six-month period. A further criticism is that it may discourage insiders from investing in securities in their own company because they are unable to realise the security during the six month period without incurring liability.<sup>98</sup>

On the other hand, section 16(b) has been remarkably effective in achieving its objectives.<sup>99</sup> This is to some extent attributable to the simplicity of the section. The elements of the action are simple, and thus the defendant in most cases will find that he has no alternative but to pay up<sup>100</sup>. It is thus recommended that the new provisions be supplemented by the enactment of an equivalent to section 16(b).

### 5.3 Prohibition of Insider Trading

Section 440F(1) of the Companies Act provides:

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<sup>96</sup> Davies op cit note 93 at 224.

<sup>97</sup> Ibid.

<sup>98</sup> It appears that this would be the case irrespective of the reason the insider decided to realise his investment. Thus the section would be applicable even if the security was obtained pursuant to a share incentive scheme. In this regard it should be noted that it is generally accepted that it is beneficial for a company to have directors and officers purchase securities in the company as they thereby acquire a direct financial interest in the company: Davies op cit note 93 at 224.

<sup>99</sup> Loss op cit note 84 at 550.

<sup>100</sup> Ibid. See also Wallace "Who is subject to the prohibition against insider trading: a comparative study of American, British and French law" (1984-1985) 15 *Southwestern University LR* 217 at 221.

"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."

**5.3.1 Knowledge that the information was obtained as provided for in paragraphs (a) and (b) of section 440F(1)**

The new provisions do not prohibit dealing in securities on the basis of unpublished price-sensitive information in circumstances where the person dealing is simply in possession of the unpublished price-sensitive information.<sup>101</sup> The new provisions

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<sup>101</sup> The "possession theory": see *SEC v Texas Gulf Sulphur Co* 401 F 2d 833 at 848 (2d Cir 1968) where the court stated: "Anyone in possession of material insider information must either disclose it to the investing public, or, if ... he chooses not to do so, must abstain from trading in or recommending the securities while such information remains undisclosed." See Van Zyl "Aspekte van Beleggersbeskerming in die Suid-Afrikaanse Reg" PhD Thesis, UNISA, March 1991 at 254. See also *United States v Chiarella* 588 F. 2d 1358 (2d Cir 1978). In this case, a printer's employee (Chiarella) decoded offer documents and bought stock of the target company. When the offer was made public, the stock rose. Chiarella argued that he was not an "insider" and accordingly could trade freely. The Court of Appeals at 1365 rejected his argument and applied the possession theory: "Anyone, corporate insider or not, who regularly receives material nonpublic information may not use that information without incurring an affirmative duty to disclose. And if he cannot disclose he must abstain from buying or selling." This formulation was rejected by the Supreme Court (*Chiarella v United States* 445 U.S. 222 at 233) where the majority opinion denied that there was "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." The Supreme Court held at 230 that "such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." See also Wallace op cit note 100 at 252.

prohibit dealing in securities on the basis of unpublished price-sensitive information where the person "knows" the information was "obtained" by the means set out in paragraphs (a) or (b) of section 440F(1).

Paragraph (a) of section 440F(1) includes within its ambit persons who obtain the unpublished price-sensitive information by virtue of being a party to a relationship of trust, or contractual relationship. It further includes persons who are not a party to the said relationships but, who nevertheless obtain the unpublished price-sensitive information and who know the information was obtained by virtue of the said relationships.

The relationship of trust or the contractual relationship is not limited to relationships of a specific nature such as that between a director and a company, or between an employee and a company, or between the parties to a share transaction.<sup>102</sup> The company in respect of whose securities a person dealt on the basis of the unpublished price-sensitive information need not be a party to the relationship of trust or the contractual relationship.<sup>103</sup>

✓ The expression "a relationship of trust" clearly includes a fiduciary relationship. It is suggested that a relationship of trust exists whenever there is a duty between parties to act in good faith towards one another and where there is an

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It should be noted that whilst section 440F(1) has not incorporated the possession theory, section 440F(3)(a) read with section 440F(3)(i) creates a presumption which provides that where it is proved at criminal proceedings that the accused was in possession of unpublished price-sensitive information in respect of the security in question at the time of the alleged dealing, that the accused shall be deemed, unless the contrary is proved, to have knowingly dealt in that security on the basis of such information.

<sup>102</sup> Van Zyl op cit note 101 at 256.

<sup>103</sup> The person who deals on the basis of the unpublished price-sensitive information need not be connected in any way with the company concerned.

expectation of confidentiality between parties.<sup>104</sup> Further, the relationship of trust need not arise from a professional or business relationship. A relationship of trust could possibly be held to include relationships of trust such as the relationship between psychiatrist and patient<sup>105</sup> and between family members.<sup>106</sup>

The expression "any other contractual relationship" refers to a relationship arising from a contract. The expression is not qualified in any way and accordingly, should be interpreted on the basis that the legislature intended by the use of the words "contractual relationship"<sup>107</sup> to convey a meaning which is generally understood.<sup>108</sup>

It will depend on the facts of each case whether it can be said that the unpublished price-sensitive information was obtained "by virtue of" a relationship of trust or contractual relationship.

Paragraph (b) of section 440F(1) refers to information obtained "through espionage, theft, bribery, fraud, misrepresentation

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<sup>104</sup> Jooste op cit note 20 at 596.

<sup>105</sup> See *United States v Willis* 737 F. Supp. 269 at 271-275 (S.D.N.Y.1990) where the District Court held that the United States could prosecute a psychiatrist, in terms of rule 10b-5 of the Securities Exchange Commission, who breached his doctor/patient duty of confidentiality by trading on information he received in the course of treating a patient.

<sup>106</sup> In *United States v Reed* 601 F. Supp. 685 at 717-718 (S.D.N.Y. 1985) the court held that the breach of a relationship of trust and confidence between family members was a sufficient basis for alleging fraud in terms of rule 10b-5 of the Securities Exchange Commission.

<sup>107</sup> Hutchison (ed) *Wille's Principles of South African Law* (1991) at 409 states: "A contract is an agreement between two or more persons which gives rise to personal rights and corresponding obligations; in other words, it is an agreement which is legally binding on the parties." See *Pattinson and another v Fell and another* 1963 (3) SA 277 (N) at 279.

<sup>108</sup> See *Estate Breet v Peri-Urban Areas Health Board* 1955 (3) SA 523 (A) at 532 where the court was interpreting the word "contract" in the context of sections 3(2)(c)(i) and 3(2)(d) of the Prescription Act 18 of 1943.

or any other wrongful method, irrespective of the nature thereof."

The words "irrespective of the nature thereof" indicate that the nature of the espionage, theft, bribery, fraud, misrepresentation or other wrongful method is irrelevant. This indicates that an innocent misrepresentation is included within the ambit of section 440F(1)(b).<sup>109</sup> It is submitted that the words further indicate that a broad interpretation is to be given to the word "wrongful" that includes methods that are not only illegal or constitute a breach of a legal duty, but are also unfair or constitute a violation of equity.

When can it be said that a person "knows"<sup>110</sup> that the unpublished price-sensitive information was obtained by the means set out in paragraphs (a) or (b) of section 440F(1)? The meaning of the word "knows" must be determined from its context.<sup>111</sup> It is submitted that something more than mere suspicion or belief would be necessary.<sup>112</sup> It is further submitted that mere knowledge of sources from which the person could ascertain whether the unpublished price-sensitive information was so obtained would not suffice.<sup>113</sup> It is suggested that a person "knows", for the purposes of section 440F(1), where the person has actual knowledge or where the person has knowledge of circumstances which ordinarily lead to the conclusion that the information was obtained by the means

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<sup>109</sup> See Luiz op cit note 9 at 329.

<sup>110</sup> *The Shorter Oxford English Dictionary on Historical Principles* (1988) defines "know" as, inter alia, "to be aware of, to apprehend or comprehend as a fact or truth".

<sup>111</sup> See *Botha v Muir* 1952 (2) SA 358 (E) at 364 where the court was dealing with the meaning of the word "knowledge" in the context of Rule 46(9) of the Magistrates Court Act 32 of 1944.

<sup>112</sup> See *Patterton v Minister van Bantoeadministrasie en Ontwikkeling* 1974 (3) SA 684 (C) at 687 where the meaning of the word "knowledge" was discussed in the context of section 29 of the Public Service Act 54 of 1957.

<sup>113</sup> *Botha v Muir* op cit note 111 at 365.

set out in paragraphs (a) or (b) of section 440F(1).<sup>114</sup> A presumption is created in terms of section 440F(3)(b) read with section 440F(3)(ii) which provides that where it is proved at criminal proceedings in terms of which the accused is charged with contravening section 440F(1), that unpublished price-sensitive information was obtained in the manner contemplated in section 440F(1)(a) or section 440F(1)(b) that the accused shall be deemed unless the contrary is proved to have known that the information was so obtained.

When can it be said that the unpublished price-sensitive information was "obtained" by the means set out in paragraphs (a) or (b) of section 440F(1)? In *Attorney-Generals Reference* the Court of Appeal of England held that the word "obtain" for the purposes of the Company Securities (Insider Dealing) Act 1985 (the IDA) includes the receipt of information where no positive steps are taken by the insider to acquire the information.<sup>115</sup> The Court of Appeal held that:

"Now, so far as gaining an unfair advantage of or, put bluntly, cheating the other party to a transaction is concerned, it makes no difference to the person cheated whether the information on which the 'tippee' is basing the cheating was sought out by him or came his way by unsolicited gift."<sup>116</sup>

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<sup>114</sup> *Strouds Judicial Dictionary of Words and Phrases* (1986) at 1394 says: "To know a thing or state of things, is not only to have precise knowledge of it; knowledge of circumstances ordinarily leading to the conclusion that the thing or state of things exists will suffice..." See *Howard v Herrigel and another NNO* 1991 (2) SA 660 (A) at 673-674 where the court discussed the meaning of "knowingly" as contained in section 424 of the Companies Act and held that it meant that "... the person sought to be held liable had knowledge of the facts from which the conclusion is properly to be drawn that the business of the company was or is being carried on recklessly ..."

<sup>115</sup> *Attorney-Generals Reference* op cit note 7 at 325.

<sup>116</sup> *Ibid.* This interpretation was affirmed by the House of Lords in *Attorney-Generals Reference* (No 1 of 1988) [1989] 2 All ER 1.



It is suggested that the same interpretation should be given to the word "obtained" in section 440F.<sup>117</sup>

**5.3.2 Any person who directly or indirectly, knowingly deals in a security on the basis of unpublished price-sensitive information**

**5.3.2.1 Deals**

To deal<sup>118</sup> in a security involves the changing of one's position in regard to the security.<sup>119</sup> A person will deal in securities if the person buys or sells securities, trades in securities or barter in securities.<sup>120</sup> A single transaction involving a security would constitute dealing in that security since to hold otherwise would mean that section 440F(1) does not include within its scope all isolated instances of insider trading.<sup>121</sup>

Since to deal in a security involves the changing of one's position in regard to the security, the mere possession of inside information does not constitute insider trading. Thus the decision not to deal on the basis of inside information would not constitute a contravention of section 440F(1) even where the person would have dealt if he were not in the possession of the inside information.<sup>122</sup> Even if it did constitute a contravention of section 440F(1), it would be extremely difficult to prove.

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<sup>117</sup> Van Zyl op cit note 101 at 255.

<sup>118</sup> The word "deals" is not defined in the Companies Act.

<sup>119</sup> Jooste op cit note 20 at 593.

<sup>120</sup> See *Robins-Browne v Cohen and others* 1939 WLD 262 at 265-6 where to deal in a commodity was held to mean to buy or sell. See also *R v Oberholzer and others* 1941 OPD 48 at 59-60 and *Corona v Minister of Home Affairs* 1982 (2) SA 533 (ZH) at 539-540.

<sup>121</sup> Van Dorsten *South African Business Entities, A Practical Guide* (1993) at 182.

<sup>122</sup> See *Gore-Browne* op cit note 1 at 12.026B.

Further, the requirement that the person must deal in the security does not imply that the person must acquire a benefit therefrom. This should be contrasted to section 233 where no offence was committed unless the offender "dealt in any way to his advantage."<sup>123</sup>

It is also apparent that the communication of inside information to another person or the counselling or procuring of another individual to deal in a security on the basis of inside information does not constitute dealing in a security, and is thus not prohibited by the new provisions.<sup>124</sup> This should be contrasted with the position in Great Britain where, in terms of the IDA, it is an offence for an individual to counsel or procure<sup>125</sup> a person to deal in securities on the basis of inside information, or to communicate inside information to other persons.<sup>126</sup>

#### 5.3.2.2 Directly or indirectly

The words "directly or indirectly" qualify the meaning of the word "deals". Direct dealing would take place where the person

<sup>123</sup> Jooste op cit note 20 at 593.

<sup>124</sup> Should the person to whom the inside information has been communicated or who has been counselled or procured to deal in a security on the basis of inside information, deal in a security on the basis of inside information, that person will be contravening the new provisions.

<sup>125</sup> Section 1(7) of the IDA. The prohibition provides that subject to section 3 of the IDA, an individual who is for the time being prohibited by any provision of section 1 of the IDA from dealing on a recognised stock exchange in any securities shall not counsel or procure any other person to deal in those securities, knowing or having reasonable cause to believe that that person would deal in them on a recognised stock exchange.

<sup>126</sup> Section 1(8) of the IDA. The prohibition provides that subject to section 3 of the IDA, an individual who is prohibited from dealing on a recognised stock exchange in any securities by reason of his having any information, may not communicate that information to any other person (including a body corporate) if he knows or has reasonable cause to believe that some or other person will make use of the information for the purpose of dealing or of counselling or procuring another person to deal in those securities on a recognised stock exchange.

does not use intermediaries. Indirect dealing would take place where the person uses intermediaries. Thus indirect dealing would probably take place where the securities are held by a company which the person controls, or where the securities are held by a trust, and the person is a trustee and has a vested interest in the income or the assets of the trust. Since the new provisions do not require that the person dealing in the security must derive a benefit therefrom, indirect dealing may also include the situation where the person deals in securities on the behalf of another party, where it is only the other party who derives any benefit from the dealing.

In addition, it is submitted that the words "directly or indirectly" qualify the words "knowingly deals in a security on the basis of unpublished price-sensitive information in respect of that security". For example, what happens where a person is simply given a hint or recommendation to buy a particular security under circumstances where the actual unpublished price-sensitive information is not communicated to him? If the person deals in the security on the basis of the recommendation he would not be dealing in the security directly on the basis of the inside information. However, it is arguable that the person is dealing indirectly on the basis of inside information in that the person is dealing on "the strength of the information forming the basis for the hint or recommendation."<sup>127</sup>

#### 5.3.2.3 On the basis of

The requirement that the person must deal "on the basis of" the unpublished price-sensitive information indicates that there must be a causal connection between the dealing in the security and the possession of the inside information. Thus the mere dealing in a security while in the possession of unpublished

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<sup>127</sup> Jooste op cit note 20 at 597.

price-sensitive information in respect of that security does not constitute insider trading if the dealing is not done on the basis of the unpublished price-sensitive information.<sup>128</sup>

Thus a stock broker who happens to be in possession of unpublished price-sensitive information in respect of a security and who is requested to deal in that security by a client would not be dealing in that security on the basis of the unpublished price-sensitive information but rather on the basis of the instruction he received from his client.<sup>129</sup>

#### 5.3.2.4 Any person

The use of the words "any person" indicates that section 440F(1) includes within its ambit both natural persons and legal entities such as companies, close corporations and trusts.<sup>130</sup> Section 440F(1) is not limited in its application to certain categories of persons who, as a result of their positions, are likely to acquire access to unpublished price-sensitive information. Section 440F(1) is applicable to all persons.<sup>131</sup>

However, section 440F(6) enables the Minister,<sup>132</sup> on the advice of the panel, by notice in the Gazette, to exempt any class of

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<sup>128</sup> The accused, where it is proved at trial that he was in possession of unpublished price-sensitive information in respect of the security at the time of the alleged dealing, will be obliged to rebut the presumption created by section 440F(3)(a) read with section 440F(3)(i) in terms of which he is presumed to have knowingly dealt in the security on the basis of the unpublished price-sensitive information.

<sup>129</sup> Van Zyl op cit note 101 at 264.

<sup>130</sup> Section 2 of the Interpretation Act 33 of 1957.

<sup>131</sup> Whilst the repealed section 233 of the Companies Act imposed liability on insiders as defined in section 229 of the Companies Act, the new provisions "impose liability on persons generally": Luiz op cit note 9 at 330. Examples of persons who potentially fall within the ambit and scope of the new provisions are directors, employees, shareholders, market professionals, researchers, analysts and government officials.

<sup>132</sup> Minister of Industries, Commerce and Tourism.

persons from the provisions of section 440F on such conditions and to such an extent as he deems fit, and at any time in like manner to revoke or amend such exemption.

The purpose of section 440F(6) is to enable the Minister to grant an exemption in the event that the new provisions are too wide and include activities within their ambit that were not intended to be included.<sup>133</sup> Section 440F(6) is a product of the uncertainties and difficulties in regulating insider trading.<sup>134</sup> The scope of the exemption is wide and thus the possible forms which the exemption may take, are numerous.<sup>135</sup>

#### 5.3.2.5 Security

A security is defined in section 440A(1) of the Companies Act and

"means any shares in the capital of a company and includes stock and debentures convertible into shares and any rights or interests in a company or in respect of any such shares, stock or debentures, and includes any 'financial instrument' as defined in the Financial Markets Control Act, 1989 (Act No. 55 of 1989)".

The definition of "security" is thus extremely wide and includes futures and option contracts.<sup>136</sup> The inclusion of derivative instruments such as futures and option contracts in the definition is necessary since the dealing in derivative instruments on the basis of inside information is, in principle, no less unfair than the dealing in shares on the

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<sup>133</sup> Botha op cit note 2 at 15.

<sup>134</sup> Ibid.

<sup>135</sup> Ibid.

<sup>136</sup> Section 233 referred only to shares and debentures, although it appears that "dealing" in section 233 included the procuring or exercising an option to purchase shares or the sale of such an option: Henochsberg op cit note 38 at 371.

basis of inside information.<sup>137</sup> However, since paragraph (i) of the definition of unpublished price-sensitive information in section 440F(2)(a) only refers to information in respect of a company, insider trading in derivatives such as index derivatives, commodity derivatives and loan stock derivatives are excluded from the prohibition in section 440F(1).<sup>138</sup> It is suggested that the prohibition on insider trading should be extended to all kinds of derivatives since the trading in such derivatives is no less unfair than the dealing in other securities.<sup>139</sup>

#### 5.3.2.6 Unpublished price-sensitive information

It will be a question of fact in each case whether or not the information in question satisfies the criteria specified in the definition of unpublished price-sensitive information contained in section 440F(2)<sup>140</sup>. The definition contains the following elements:

- (i) the nature of the information;
- (ii) the availability of the information; and
- (iii) the price-sensitivity of the information.

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<sup>137</sup> See Goodman "Trading in Commodity Futures Using Nonpublic Information" 1986 *Sec LR* 273 at 280. Van Zyl op cit note 101 at 249.

<sup>138</sup> Van Zyl "Insider Trading: Law and Ethics", seminar presented by the Research Unit for Banking Law of the Rand Afrikaans University, 25 June 1993 at 4.

<sup>139</sup> Ibid.

<sup>140</sup> In terms of section 440F(2)(a) unpublished price-sensitive information means information which -

- "(i) relates to matters in respect of the internal affairs of a company or its operations, assets, earning power or involvement as offeror or offeree company in an affected transaction or proposed affected transaction;
- (ii) is not generally available to the reasonable investor in the relevant markets for that security; and
- (iii) would reasonably be expected to affect materially the price of such security if it were generally available."

### 5.3.2.6.1 The Nature of the Information

The information must be information that

"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"<sup>141</sup>.

The phrases "relates to matters" and "in respect of" prima facie extend the ambit and scope of the matters referred to in section 440F(2)(a)(i). The aforesaid phrases are, however, ambiguous in that they have an elastic quality in terms of which they can be interpreted as requiring a direct relationship or an indirect or remote relationship to the matters referred to in section 440F(2)(a)(i).<sup>142</sup> Thus the scope of this element is uncertain and is dependent on whether the courts interpret the aforesaid phrases widely or narrowly.<sup>143</sup>

No distinction is drawn between specific and general information.<sup>144</sup> Specific information is clearly included but

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<sup>141</sup> Section 440F(2)(a)(i) of the Companies Act.

<sup>142</sup> See *Commissioner for Inland Revenue v Butcher Bros (Pty) Ltd* 1945 AD 301 at 320 where it was held that: "The expression 'in respect of' is one which indicates a relationship which may be a direct or causal relationship ... but I do not think that it necessarily or invariably indicates such a relationship". See also *Ex parte M. Braude & Co* 1936 CPD 480 at 482-483 where the expression "relating to" was held to indicate a very loose or indirect relationship.

<sup>143</sup> The correct approach to the interpretation of the expression "in respect of" was set out in *Rabinowitz and another v De Beers Consolidated Mines Ltd and another* 1958 (3) SA 619 (A) at 631 as follows: "But expressions like 'in respect of' and 'in connection with', though they may sometimes be used to cover a wide range of association, must in other cases be limited to the closer or more direct forms of association indicated by the context."

<sup>144</sup> The distinction between general and specific information lies in the distinction between day-to-day knowledge and knowledge of important factors which, when revealed to the market, will move the price of shares: Hannigan op cit note 5 at 52.

it is uncertain whether the definition includes general information. This should be contrasted with the position in the United Kingdom where the definition of unpublished price-sensitive information distinguishes between information of a general nature and information of a specific nature, and excludes information of a general nature.<sup>145</sup>

Corporate information<sup>146</sup> is included within the scope of the definition. The question arises whether market information<sup>147</sup> is also included. An example of market information would be prior knowledge that a respected firm of stock brokers is about to release a favourable report about a company.<sup>148</sup> A trader could trade as profitably on such information as he could on prior knowledge that a company is about to release better-than-expected financial results.<sup>149</sup> In the event that the phrases "relates to matters" and "in respect of" are interpreted broadly, it is arguable that market information is included within the ambit of the definition of unpublished price-sensitive information.

The particular reference to information that relates to a company's involvement in an affected transaction or proposed affected transaction is not surprising since most insider

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<sup>145</sup> The IDA does not provide a test for distinguishing between general and specific information. Section 10(a) of the IDA refers to information that "relates to specific matters relating or of concern (directly or indirectly) to that company, that is to say, is not of a general nature relating or of concern to that company".

<sup>146</sup> Suter op cit note 6 at 31 defines corporate information as information that "emanates from within the company and directly relates to expected earnings and assets".

<sup>147</sup> Branson "American Business Law Insider Trading - II The British Regulation in the Light of the American Experience" 1982 *J Bus L* 413 at 414 defines market information as "information about the market for a company's shares rather than about the company itself."

<sup>148</sup> Ibid.

<sup>149</sup> Ibid.



dealing transactions take place in relation to take-overs.<sup>150</sup> The definition of affected transaction<sup>151</sup> makes it clear that transactions affecting the control of a company fall within the scope of the new provisions.<sup>152</sup> This is a substantial improvement on section 233 which did not prevent an insider in terms of section 233 from dealing in the shares of a target company even where he had knowledge of an intended take-over of the target company by his own company.<sup>153</sup> The prohibition in section 233 applied only to the dealing in the shares and debentures of the insider's own company.

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<sup>150</sup> Jooste op cit note 20 at 595.

<sup>151</sup> An "affected transaction" has been defined in section 440A(1) of the Companies Act as meaning: "any transaction (including a transaction which forms part of a series of transactions) or scheme, whatever form it may take, which -

- (a) taking into account any securities held before such transaction or scheme, has or will have the effect of -
  - (i) vesting control of any company (excluding a close corporation) in any person, or two or more persons acting in concert, in whom control did not vest prior to such transaction or scheme; or
  - (ii) any person, or two or more persons acting in concert, acquiring, or becoming the sole holder or holders of, all the securities, or all the securities of a particular class, of any company (excluding a close corporation); or
- (b) involves the acquisition by any person, or two or more persons acting in concert, in whom control of any company (excluding a close corporation) vests on or after the date of commencement of section 1(c) of the Companies Second Amendment Act, 1990, of further securities of that company in excess of the limits prescribed in the rules."

The definition of "affected transaction" was amended by section 1(c) of the Companies Amendment Act 69 of 1990 and was put into operation with effect from 1 February 1991 in terms of Government Notice R11 in *Government Gazette* 12997 of 1 February 1991 (Reg. Gaz. 4646).

<sup>152</sup> Jooste op cit note 20 at 595.

<sup>153</sup> Van Zyl op cit note 1 at 79.

### 5.3.2.6.2 The Availability of the Information

The price-sensitive information is unpublished where it "is not generally available to the reasonable investor in the relevant markets for that security".<sup>154</sup>

The determination of who constitutes "the reasonable investor in the markets for that security" is likely to be problematic and cause uncertainty.<sup>155</sup> Investors do not all have the same objectives. An investor who has invested in a security in order to obtain a long term capital gain is not likely to monitor the information regarding that security as closely as the investor who wishes to deal in the security in order to make profits over the short term. Thus the information is not likely to become generally available to both types of investors at the same time. Which investor is the reasonable investor for the purposes of section 440F?

Would the courts, in determining who the reasonable investor is, limit themselves to market professionals, or would they include the wider investing public? In the case of the former, market professionals would be advantaged, since as soon as they as a group know of the information, they would be able to invest even if the general public do not know of the information.<sup>156</sup> The word "investor" strongly indicates that members of the investing public must be included.

The difficulties in determining the reasonable investor from a group comprising market professionals and the investing

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<sup>154</sup> Section 440F(2)(a)(ii) of the Companies Act.

<sup>155</sup> By comparison, section 10(b) of the IDA refers to information "not generally known to those persons who are accustomed or would be likely to deal in those securities but which would if it were generally known to them be likely materially to affect the price of those securities."

<sup>156</sup> Hannigan op cit note 5 at 56.

public are apparent.<sup>157</sup> Market professionals and the investing public have very different levels of knowledge, expertise, understanding of, and involvement with securities and financial markets. In addition, in South Africa, the education standards of the individuals comprising the general investing public varies considerably.

"Generally available"<sup>158</sup> is defined in section 440F(2)(b) to mean available in the sense that such steps have been taken, and such time has elapsed, that it can reasonably<sup>159</sup> be expected that the unpublished price-sensitive information is or should be known to the reasonable investor in the relevant markets for that security. This definition affords the courts a measure of discretion to determine on the facts and circumstances of each case whether or not there has been an adequate dissemination<sup>160</sup> of the information.<sup>161</sup> It does not however, give any guidance regarding the steps to be taken<sup>162</sup> or the time period that must first lapse and is thus likely to

<sup>157</sup> See *R v Nkomo* 1964 (3) SA 128 (SR) at 131-132 where Beadle CJ discussed the difficulties of determining the reasonable man.

<sup>158</sup> In the United States, "generally available" has been held to mean that the information must be in a form which is readily translatable into investment action: *SEC v Texas Gulf Sulphur Co* op cit note 101 at 854. See *Van Zyl* op cit note 101 at 252.

<sup>159</sup> The word "reasonably" indicates that the courts will probably apply an objective standard in determining whether the information is generally available to the reasonable investor.

<sup>160</sup> In the United States, an effective period for the dissemination of the information is required: *Branson* op cit note 147 at 413. See *SEC v Texas Gulf Sulphur Co* op cit note 101 at 853-854.

<sup>161</sup> *Van Zyl* op cit note 101 at 251. The real time necessary for information to become generally available will depend on the exposure given the information and the analysis it generates: *Wallace* op cit note 100 at 249. Small and relatively unknown firms are at a disadvantage in making the information generally available, since large and prestigious firms will be able to command more media attention. It follows that insiders in the smaller firms will be obliged to wait a longer period before they can trade in their securities: *Branson* op cit note 147 at 414.

<sup>162</sup> Theoretically, publication in any recognised medium is not required. The price-sensitive information could become generally available by means of word of mouth or some similar means of communication.

cause confusion. Examples of possible sources of confusion are: the size of the circulation of the publication; the nature of the publication; whether publication in both official languages is necessary; and whether publication in a black language is necessary.<sup>163</sup>

The advantage of the definition of "generally available" is its flexibility. The disadvantage is its uncertainty. This uncertainty is likely to cause a prudent investor to cease trading in the security until he is sure the information is "generally available". Prudent investors may thus wait longer than is necessary before trading in the security.

It is nevertheless felt that this disadvantage is preferable to the disadvantages inherent in the inflexible approach that was contained in section 233. Section 233 lifted the ban on insider trading once the information had been publically announced on a stock exchange or in a newspaper or through the medium of the radio or television. There was thus certainty regarding when a person could trade but the inflexibility meant that:

"A public announcement could have been made in circumstances which still might not have made the information in fact generally available to the public (the timing of the announcement may have had an important bearing on making the information generally available), but which would nevertheless have left the insider free to deal, or at least be amongst the first to deal."<sup>164</sup>

#### **5.3.2.6.3 Price Sensitivity**

The unpublished information is price-sensitive if it "would"<sup>165</sup>

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<sup>163</sup> Jooste op cit note 20 at 594.

<sup>164</sup> Luiz op cit note 9 at 331.

<sup>165</sup> "Would" indicates a higher degree of probability than the use of the word "might" would have indicated: *Gerstle v Gamble-Skogma Inc* 478 F 2d 1281 at 1302 (2d Cir 1973). See Van Zyl op cit note 101 at 253.

reasonably be expected to affect materially<sup>166</sup> the price of such security if it were generally available."<sup>167</sup>

It is clearly not necessary that the information actually affects the price of the securities. It must simply reasonably be expected to do so<sup>168</sup>, presumably in the eyes of the reasonable investor. The use of the word "reasonably" indicates an objective standard.<sup>169</sup> The consequence of an objective standard is to prevent an insider from escaping liability on the basis of his own subjective belief as to the likely effect of information on the price of securities.

The difficulties involved in determining whether the information was available to the reasonable investor may be resolved to an extent by this element of the definition of unpublished price-sensitive information.<sup>170</sup> If the information did have a material impact on the price of the securities, then it follows that it was not generally available to the reasonable investor.<sup>171</sup> This element also indicates that it was not the intention of the legislature to include general information within the ambit and scope of the definition.<sup>172</sup> This is because it indicates that the legislature was concerned with information that would have a noticeable impact on the price of the securities rather than information falling within the day-to-day knowledge of directors, employees or market

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<sup>166</sup> "Materially" connotes a change that is considerable or important. For a discussion on the meaning of the word "material" see *Oatorian Properties (Pty) Ltd v Maroun* 1973 (3) SA 779 (A) at 785 and *Arendse v Badroodien* 1971 (2) SA 16 (C) at 18.

<sup>167</sup> Section 440F(2)(a)(iii) of the Companies Act.

<sup>168</sup> See *Gore-Browne* op cit note 1 at 12.027-12.028.

<sup>169</sup> *Jooste* op cit note 20 at 595.

<sup>170</sup> See *Hannigan* op cit note 5 at 56.

<sup>171</sup> *Idem* at 57.

<sup>172</sup> *Ibid.*

professionals.<sup>173</sup> Thus in practice, this element of the definition of unpublished price-sensitive information may be the decisive element.<sup>174</sup>

Section 10(b) of the IDA refers to information "... likely materially to affect the price ...". There is uncertainty whether this phrase connotes a test that is subjective or objective.<sup>175</sup> In the United States the materiality test is formulated in different ways, but its purpose is usually to facilitate a distinction between significant matters and those which are not important enough to affect substantially an investment decision.<sup>176</sup> The test is an objective one in regard to open market transactions.<sup>177</sup> With direct personal transactions, whilst the test is essentially objective, an element of subjectivity has been introduced by taking into account the relations between the parties.<sup>178</sup>

#### **5.4 The Criminal Offence**

A contravention of section 440F(1) is a criminal offence. The use of the word "knowingly" implies that mens rea is an element of the offence in the form of dolus rather than culpa.<sup>179</sup>

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<sup>173</sup> Ibid.

<sup>174</sup> Ibid.

<sup>175</sup> Suter op cit note 6 at 103.

<sup>176</sup> Ibid.

<sup>177</sup> Ibid.

<sup>178</sup> Ibid.

<sup>179</sup> *S v Bezuidenhout* 1979 (3) SA 1325 (T) at 1327. Milton *South African Criminal Law and Procedure III: Statutory Offences* (1988) by Milton and Cowling chap 2 at 10.

In South African law, in regard to statutory offences, legal intention<sup>180</sup> will suffice unless the statute expressly requires intent of a particular kind.<sup>181</sup> It is suggested that section 440F does not require intention of a particular kind, and accordingly that legal intention will suffice.

Where *dolus* is the *mens rea* of a statutory offence, *dolus* must relate to all the elements of the offence and, as such "imports as an element of liability, proof of knowledge of unlawfulness."<sup>182</sup> Thus the state must prove that the accused acted with knowledge of the unlawfulness of his act.<sup>183</sup> In other words, that the accused was aware that he was contravening the law.<sup>184</sup>

To rebut the presumption created by section 440F(3)(a) read with section 440F(3)(i) of the necessary criminal intention, the accused will have to prove on a balance of probabilities that he did not know that his conduct was unlawful.<sup>185</sup> The accused would lack knowledge of unlawfulness where he acts

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<sup>180</sup> Intention can be divided into two types, namely actual and legal intention. Actual intention exists where it was the accused's aim to do the unlawful act, or where, although not the accused's aim and object, he foresaw the unlawful act as certain (*dolus directus* or *indirectus*). Legal intention exists where the accused does not mean the unlawful act but he foresees it as a possible result of his act (*dolus eventualis*): Burchell and Hunt *South African Criminal Law and Procedure Volume I General Principles* (1983) at 136-137.

<sup>181</sup> *Idem* at 220-221.

<sup>182</sup> Milton *op cit* note 179 at 18.

<sup>183</sup> *S v Magidson* 1984 (3) SA 825 (T) at 830: Ackerman J stated "*Dolus*, however, also requires knowledge of the unlawfulness of the act. ... Such actual knowledge, however, may also be by way of *dolus eventualis*. It is also not necessary that the accused must be aware that he is contravening a specific section of a specific Act. It is sufficient if he knows that what he is doing is unlawful. Nor does the accused have to be certain that what he is doing is unlawful. It is sufficient if he realises that what he is doing may possibly be unlawful and reconciles himself with this possibility."

<sup>184</sup> Milton *op cit* note 179 at 18.

<sup>185</sup> Van Dorsten *op cit* note 121 at 179-180. See also *S v Ngwenya* 1979 (2) SA 96 (A) at 101-102.

under bona fide ignorance of the law.<sup>186</sup> Such ignorance may exist where the accused is unaware of the existence of section 440F or because the accused has received incorrect advice as to the law.<sup>187</sup> Since the test whether the accused has the necessary criminal intention is subjective<sup>188</sup>, the reasonableness of the accused's error of law or fact is irrelevant.<sup>189</sup> The concept of reasonableness or unreasonableness, and the degree thereof in the circumstances of each case, only becomes relevant in connection with the proof of whether the accused acted bona fide or not, that is, whether or not the accused was genuinely mistaken.<sup>190</sup> Since the accused must prove that he believed his conduct was not unlawful, the unreasonableness of the accused's belief could affect his credibility and thereby make it more difficult for the accused to discharge the onus.<sup>191</sup>

In a multifunctional company with a separate legal personality any unpublished price-sensitive information regarding a security in the possession of one division would mean that the company itself has knowledge thereof.<sup>192</sup> Thus should another division of that company deal in that security the company would knowingly have dealt in that security while in possession of unpublished price-sensitive information regarding that security.

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<sup>186</sup> Milton op cit note 179 at 19. A defence of ignorance of the law will succeed if it appears from the evidence as a whole that there is a reasonable possibility that the accused did not know that his act was unlawful: *S v De Blom* 1977 (3) SA 513 (A) at 532.

<sup>187</sup> Milton op cit note 179 at 19.

<sup>188</sup> *R v Mkhize* 1951 (3) SA 28 (A) at 33.

<sup>189</sup> Van Dorsten op cit note 121 at 180. See also *S v Sam* 1980 (4) SA 289 (T) at 294.

<sup>190</sup> *S v Sam* op cit note 189 at 294.

<sup>191</sup> Van Dorsten op cit note 121 at 180.

<sup>192</sup> Jooste op cit note 20 at 597.



However, as Jooste<sup>193</sup> points out, in addition to such knowledge it must also be proved that the dealing was "on the basis" of the inside information before it can be held that the multifunctional company contravened the provisions of section 440F(1). In the light of the aforesaid presumption of the necessary criminal intention, it will be difficult for the multifunctional company to avoid liability.<sup>194</sup> The multifunctional company would be obliged to establish that it did not deal on the basis of the unpublished price-sensitive information but rather, for example, on the basis of an instruction from a client. It would assist the multifunctional company in rebutting the presumption to lead evidence that it had constructed a Chinese Wall and accordingly that the unpublished price-sensitive information did not flow to the division dealing in the security.<sup>195</sup>

#### **5.4.1 The Criminal Sanction**

Section 441(1)(a) provides that the penalty for contravening section 440F(1) shall be "a fine not exceeding R500 000,00 or imprisonment for a period not exceeding 10 years or to both such fine and such imprisonment."

Since there is, as yet, no data in South Africa on the conviction of insider traders, it will be difficult to ascertain the deterrent effect of the penalty. The rewards to

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<sup>193</sup> Idem at 598.

<sup>194</sup> Ibid.

<sup>195</sup> Section 11 of the Securities Amendments Act of 1988 of New Zealand extends to organisations a defence to insider trading, where the organisation has developed a reasonably designed structure that assures that the trading division at the time of trading did not have in its possession inside information, which was within the knowledge of another employee of the organisation. See Cox "An Economic Perspective of Insider Trading Regulation and Enforcement in New Zealand" (1990) 4 *Canterbury LR* 268 at 281-282.

be gained from insider trading will clearly affect the efficacy of the penalty.<sup>196</sup>

It seems possible that the rewards from insider trading can be so high that the penalty is not an effective deterrent.<sup>197</sup> Thus it is suggested that a penalty be flexible and related to any gains made from insider trading.<sup>198</sup> In the U.S.A. a penalty of three times the illegal profits made can be imposed.<sup>199</sup> In the United Kingdom, no limit is placed on the amount of the fine that can be imposed.<sup>200</sup>

### 5.5 The Statutory Civil Remedy

The purpose of a civil remedy is to compensate the outsider for the loss suffered by the outsider, and simultaneously act as a deterrent against insider trading by depriving the insider of his gains.<sup>201</sup>

Section 440F(4)(a) creates a statutory civil remedy by providing that any person who contravenes section 440F(1) shall be liable to any other person for any loss or damage suffered by that person as a result of such contravention. Section 440F(4)(b) provides that in dealings in a security on a stock exchange or a financial market as defined in section 1 of the

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<sup>196</sup> The probability of detection and the severity of punishment play a major role in reducing the incidence of the crime of insider trading: see Botha "The Economics of the Crime and Punishment of Insider Trading in South Africa" (1992) 4 SA Merc LJ 145 at 148-156.

<sup>197</sup> Botha "Increased Maximum Fine for Insider Trading: A Realistic and Effective Deterrent?" (1990) 107 SALJ 504 at 504-508.

<sup>198</sup> Jooste op cit note 20 at 599.

<sup>199</sup> Section 21(d)(2)(A) of the Securities Exchange Act 15 U.S. (78/qq) (1984). See also Jooste op cit note 20 at 599.

<sup>200</sup> Section 8(1)(a) of the IDA.

<sup>201</sup> The motive for insider trading is to make profits. Thus, if the profit incentive is removed, the incidence of insider trading should decrease.

Financial Markets Control Act 55 of 1989, that the plaintiff need not prove intention or negligence towards the plaintiff in an action contemplated in section 440F(4)(a). It is suggested that the rationale behind this exclusion arises from the anonymity that characterises stock exchange transactions which would render proof of negligence or intention practically impossible.<sup>202</sup> Intention or negligence must be proven in cases where the dealing does not take place on the markets referred to in section 440F(4)(b). Since the conclusion of these transactions will normally be preceded by face-to-face negotiations, the proof of intention or negligence should not be too difficult for the plaintiff.

The use of the words "any person who contravenes subsection 1" in section 440F(4)(a) means that a plaintiff who wishes to avail himself of the statutory remedy is required to prove that the defendant contravened section 440F(1). The plaintiff must prove all the elements of the offence. Since the action brought by the plaintiff is a civil action, the plaintiff will be obliged to prove such contravention on a balance of probabilities.<sup>203</sup> In addition, the use of the word "contravenes" in section 440F(4)(a) as opposed to the words "is convicted of contravening" suggests that it is not necessary that the person be convicted of contravening section 440F(1).<sup>204</sup>

The words "as a result of such contravention" in section 440F(4)(a) indicate that the plaintiff must prove that his loss or damage<sup>205</sup> occurred as a result of the contravention of section 440F(1). There must be a causal connection between the

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<sup>202</sup> Luiz op cit note 9 at 331.

<sup>203</sup> Jooste op cit note 20 at 603.

<sup>204</sup> Ibid.

<sup>205</sup> The plaintiff's loss or damage would probably be the difference between the price that the plaintiff traded at, and what the transaction price would have been if the inside information had been generally known: Jooste op cit note 20 at 603.

loss or damage and the contravention of section 440F(1).<sup>206</sup> Thus the plaintiff's loss or damage must be caused by the defendant's knowingly dealing in the security on the basis of unpublished price-sensitive information.<sup>207</sup> The question arises whether the plaintiff's loss is in fact caused by the defendant's dealing in the security on the basis of unpublished price-sensitive information? Jooste suggests that in most cases it would not be, since most insider trading transgressions involve stock exchange transactions where the aggrieved party would have bought or sold the shares at the same price irrespective of whether there had been insider trading or not.<sup>208</sup> Thus one cannot say that the aggrieved party suffered the loss as a result of the insider trading.<sup>209</sup>

In addition, the plaintiff, in order to succeed with the statutory civil remedy must establish the identity of the defendant and that the defendant caused the plaintiff's loss.<sup>210</sup> Given the anonymity that characterises stock exchange transactions, this will, in most cases, be practically impossible.<sup>211</sup> The American answer to this problem has been to do away with the privity requirement.<sup>212</sup> It is thus not necessary to show that the defendant bought from or sold to the plaintiff. The only proof needed is that the defendant traded

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<sup>206</sup> Ibid.

<sup>207</sup> Ibid.

<sup>208</sup> Ibid.

<sup>209</sup> Ibid.

<sup>210</sup> Idem at 604-605.

<sup>211</sup> It appears that the statutory civil remedy will be entirely ineffective with regard to stock exchange transactions and that the deterrent value of the statutory civil remedy will be limited.

<sup>212</sup> *Fischman v Raytheon Mfg. Co.* 188 F 2d 783 at 786-789 (2d Cir 1951) is regarded as the first case articulating a departure from the common law privity requirements. See Branson "American Business Law Insider Trading - III The British Regulation in the Light of the American Experience" 1982 *J Bus L* 536 at 536.

in the same time period that the plaintiff traded.<sup>213</sup> In certain instances this resulted in a multiplicity of actions being brought against a defendant with the result that the defendant became liable to pay out to plaintiffs a far greater sum than the profits made or loss avoided by the defendant.<sup>214</sup> Clearly this result is undesirable. The U.S. courts have remedied this problem by limiting the liability of the defendant to the profit made or the loss avoided by the defendant.<sup>215</sup> Relaxation of the privity requirement nevertheless creates the fortuitous plaintiff - whether or not the defendant traded, the plaintiff would have bought or sold the shares.<sup>216</sup> On recovery, the plaintiff makes a windfall gain.<sup>217</sup> The fortuitous plaintiff is morally acceptable if the objective of the legislation is deterrence and punishment rather than compensation.<sup>218</sup>

It is further submitted that in general a private civil remedy is neither an effective deterrent nor an effective means of enabling victims to claim compensation.<sup>219</sup> It is suggested that this is due in part to the following reasons:

- (1) The determination of the identity of the insider may entail the need to have access to the records of the insider's broker which could be time-consuming and hence

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<sup>213</sup> Branson op cit note 212 at 536.

<sup>214</sup> Idem at 537.

<sup>215</sup> Ibid. *Elkind v Liggett and Meyers Inc.* 635 F 2d 156 at 168-173 (2d Cir 1980).

<sup>216</sup> Branson op cit note 212 at 539.

<sup>217</sup> Ibid.

<sup>218</sup> Ibid.

<sup>219</sup> Private litigation has not been an effective deterrent in the USA: Cox op cit note 195 at 275.

costly.<sup>220</sup> Since the search may be fruitless, an outsider may be hesitant to even commence the search.<sup>221</sup>

- (2) The action is likely to be expensive<sup>222</sup> and the risk of failure is not insignificant. This is likely to deter the outsider from instituting action.
- (3) The insider will only have to pay to the outsider the loss or damage the outsider has suffered. This means that an insider will only have to disgorge the profits he made or make a payment equivalent to the loss he avoided. Thus from a civil remedy perspective it is worth the risk for the insider to trade. If he is not sued, he makes a profit, or avoids a loss, and if he is sued, he is in no worse position than he would have been if he had not traded.<sup>223</sup>

It is thus proposed that the panel be empowered, in the public interest, to institute a civil action against insiders.<sup>224</sup> The panel's cause of action would be against any person who contravened the provisions of section 440F(1) and would simply require proof that the defendant contravened the provisions of section 440F(1). It is suggested that the panel be entitled to recover punitive damages of up to three times the profit made or the loss that was avoided. The damages would be utilised to pay for the costs of the investigation, to contribute towards the general costs of the surveillance of the securities market

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<sup>220</sup> See Gillen "Sanctions against Insider Trading: A Proposal for Reform" (1991) 70 *Can Bar R* 215 at 233.

<sup>221</sup> *Ibid.*

<sup>222</sup> Even if the outsider succeeds in his action, generally he will not recover full legal costs.

<sup>223</sup> Cox *op cit* note 195 at 279-280.

<sup>224</sup> This proposal is based on Gillen's proposals for the Canadian insider trading provisions: See Gillen *op cit* note 220 at 240-242.

for the purposes of the detection of insider trading, and to compensate the outsider who traded with the insider.<sup>225</sup>

Such an action is more likely to be instituted than a private civil action since the panel in most instances will have more resources than a private litigant. The panel, due to its powers in terms of section 440D, will be able to conduct the necessary investigations to obtain the information needed to bring a successful civil action.<sup>226</sup> The lower standard of proof required in civil actions means that it is easier to succeed in such an action as opposed to a criminal action. The provision for punitive damages means that the incentive to bring the action is higher than under the present statutory civil remedy where only normal damages can be recovered.<sup>227</sup> In addition, by enabling the outsider to be compensated from these damages the need for the outsider to bring his own action is obviated. In this way, a potentially wasteful secondary action by the outsider can be avoided. Further, the social stigma attached to an action brought by the panel is likely to be greater than that attached to a private action.

Is a contract in contravention of section 440F void? In *Metro Western Cape (Pty) Ltd v Ross*<sup>228</sup>, the court stated that:

"As a general rule a contract impliedly prohibited by statute is void and unenforceable but this rule is not inflexible or inexorable. Although a contract is in violation of a statute it will not be declared void unless such was the intention of the Legislature and this is nonetheless the rule in the case of a contract in violation of a statute which imposes a criminal sanction. The legislative intent not to render void a contract may be inferred from

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<sup>225</sup> *Idem* at 240.

<sup>226</sup> *Idem* at 241.

<sup>227</sup> *Ibid.*

<sup>228</sup> 1986 (3) SA 181 (A) at 188. See also *Standard Bank v Estate Van Rhyn* 1925 AD 266 at 274-275; *Luke and Co. v Pretorius* 1938 TPD 463 at 467-468; and *Eland Boerdery (Edms) Bpk v Anderson* 1966 (4) SA 400 (T) at 405.

the general rules of interpretation. Each case must be dealt with in the light of its own language, scope and object and the consequences in relation to justice and convenience of adopting one view rather than the other."

It is suggested that, in the light of the scope and object<sup>229</sup> of section 440F and from a perspective of convenience and justice<sup>230</sup>, it is preferable to adopt the view that transactions in contravention of section 440F are not void.<sup>231</sup>

Is a contract in contravention of section 440F voidable at the option of the outsider? It is submitted that a contract is voidable if the underlying consensus has been obtained in an improper manner.<sup>232</sup> The underlying consensus would be obtained in an improper manner where the one party "acted in a manner which according to the generally recognised norms of conduct is not acceptable and reasonable."<sup>233</sup> To trade on the basis of inside information is unlawful and accordingly, it is submitted, the underlying consensus would have been obtained in a manner which is not acceptable and reasonable. Accordingly, it is my opinion that a contract in contravention of section 440F is voidable at the option of the outsider.<sup>234</sup>

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<sup>229</sup> It is suggested that the scope and object of section 440F is to prevent insider trading, punish insiders by means of a criminal sanction and provide redress to outsiders by means of a statutory civil action and not to render void any insider dealing transaction: see Jooste op cit note 20 at 605-606.

<sup>230</sup> It is submitted that, given the impersonal nature of stock exchange transactions and the difficulty in identifying the parties to a particular transaction, to hold transactions in contravention of section 440F void, would result in such transactions being void without the parties thereto being aware of it. In addition, where the transaction has been completed, restitution would be problematic: see Jooste op cit note 20 at 606.

<sup>231</sup> Ibid.

<sup>232</sup> Van der Merwe and Van Huyssteen "Improperly Obtained Consensus" (1987) 50 *THRHR* 78 at 78-82. See also *Plaaslike Boeredienste (Edms) Bpk v Chemfos* 1986 (1) SA 819 (A) at 848.

<sup>233</sup> Van der Merwe and Van Huyssteen op cit note 232 at 79.

<sup>234</sup> See Jooste op cit note 20 at 606.



## 6. CONCLUSION

It is apparent from the aforementioned that the common law and the now repealed section 233 of the Companies Act were inadequate for the purposes of preventing the trading on the basis of inside information from taking place or in providing an adequate remedy to outsiders.

In order to remedy these inadequacies and to promote investor confidence in the integrity of the securities markets, the legislature introduced the new provisions.

Whilst the new provisions are a substantial improvement on section 233, certain aspects of the new provisions need to be reconsidered. Its scope should be widened to include trading on the basis of inside information in all kinds of derivative instruments. Further, the statutory civil remedy will not be of assistance to most victims of insider trading and accordingly needs to be reformulated. It may well be that the only feasible solution to the difficulties of drafting an effective civil remedy in respect of stock exchange transactions, is to do away with the privity requirement. Since private litigation is not an effective deterrent to trading on the basis of inside information, or an effective means of compensating outsiders, consideration should be given to the empowerment of the panel, in the public interest, to institute a civil action against insiders and in terms thereof recover punitive damages from the insider of up to three times the profit made or the loss that was avoided. The damages so recovered can be used for the costs of the enforcement of the new provisions and to compensate those persons who have suffered losses due to others trading on the basis of inside information.

The presumptions created in terms of section 440F(3) of the new provisions are likely to assist the state in successfully

prosecuting persons trading on the basis of inside information in terms of section 440F. However, in the light of the substantial profits that can be made from trading on the basis of inside information, the criminal penalty appears to be insufficient and thus an ineffective deterrent. The quantum of the fine should bear a relationship to the profit made or the loss avoided.

Substantial reliance has been placed on the panel to monitor and investigate alleged trading on the basis of inside information. Should the panel fail in its task of monitoring and investigating alleged insider trading activities, the new provisions will be of little use in regulating insider trading. If insider trading laws are to be obeyed they must be enforced. It is thus imperative that the panel be adequately financed so that it can fulfil its substantial role in regulating the trading on the basis of inside information in South Africa.

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