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The Journey from Insider Trading to Market Abuse – Have we succeeded it curbing the scourge?

Sibani Mngomezulu
Executive: Barloworld Equipment

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What constitutes "insider trading?"

- In essence, 'insider trading' refers to trading in securities on the basis of information that has not been made public

What constitutes "inside information?"

- Insider trading was regarded as having occurred where there was a prospect of abuse of the 'inside information'
- Inside information is information regarding a company that if it were to be made public, would affect the company's share price

Practical examples of insider trading

- Persons with advance knowledge of an imminent takeover (*e.g.* Directors, company officers and employees – *'Primary insiders')* buy securities in the target company in the expectation that the securities will rise, creating a gain, once the transaction is announced
- Directors, company officers and employees (the "tippers") in possession of material, non-public information share that information with friends, relatives and business associates (the 'tippees' – *'Secondary insiders')* who trade on that information
- Employees of professional service firms (*e.g.* law firms, financial advisors, auditing firms) receive material, non-public information in the course of executing their duties and they trade on that information

Why regulate insider trading?

Reasons advanced for regulating insider trading, include the following:

- Insider trading reduces public confidence in the markets
- Worsens the manager-shareholder conflict
- Enables fairness and equal access for market participants

The Naysayers

- Those who argue that the regulation of insider trading is undesirable, advance the following reasons in support of their argument:

  - *Insider trading can be beneficial to the markets*
  - *Not all insider trading cases are fraudulent*
  - *Insider trading can sometimes be regarded as a 'victimless crime'*
  - *If it is a 'crime' at all, then government resources should be employed elsewhere to address 'more reprehensible' conduct*

Permissible ‘insider trading’

- When company insiders (namely Directors, company officers and employees) trade in their own securities outside of a ‘restricted period’ or ‘closed period’
- Internal approval processes must be followed by company insiders and it may be required that any such trades be reported to the market
- Where company insiders are in possession of non-public information that cannot be regarded as being ‘material’ – *namely information that can be regarded as being ‘price sensitive’*
- Where company insiders are in possession of material information that is already in the public domain

Regulatory Landscape

Prior to 1973

Insider trading was not prohibited by legislation

Insider trading proved rampant

Lack of insider trading legislation and enforcement discouraged foreign & local investment, with low confidence in SA financial markets

Commission of inquiry instituted to investigate regulation of insider trading

Regulatory regime - SA

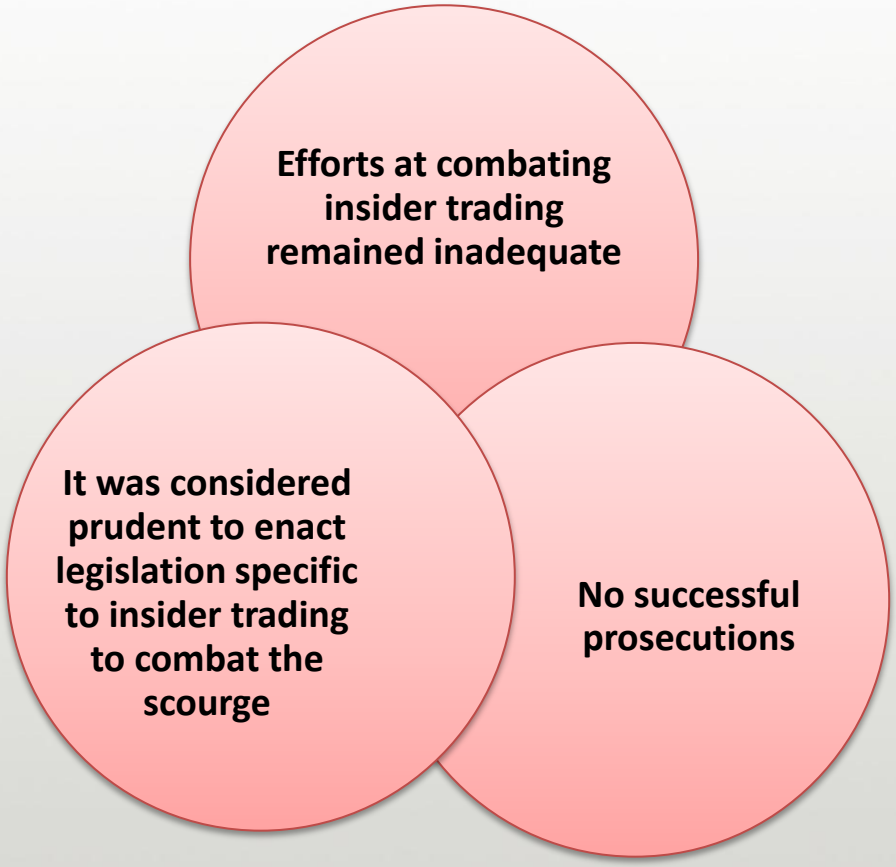
Post 1973

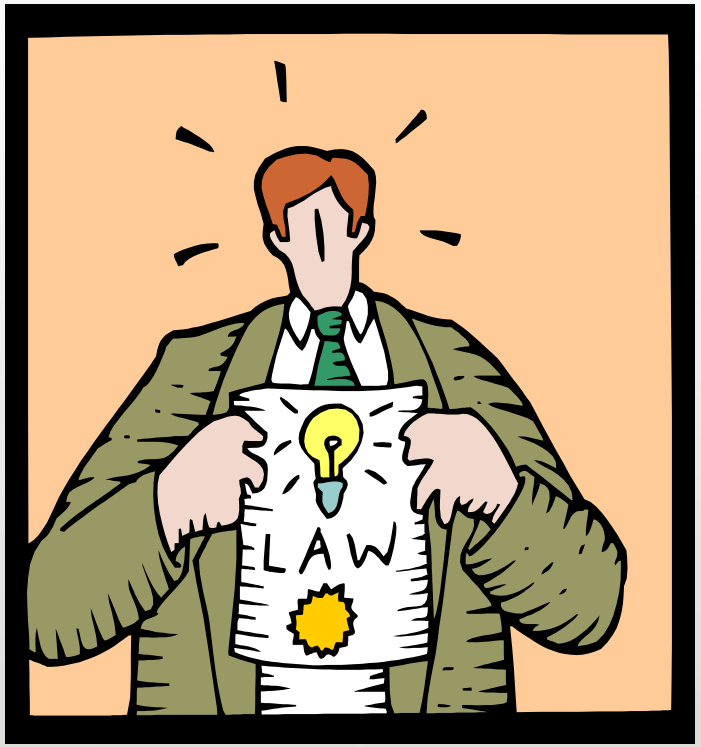
- Insider trading was made illegal by the Companies Act, 1973
- Initially section 233 prohibited insider trading
- s233 prohibition covered insider trading by primary insiders only
- ‘Price sensitive information’ was not defined
- Only applied to listed securities
- Extended only to securities covered by the Act
- Absence of mandatory disclosure requirements
- Insider trading was treated a criminal offence; with high standard of proof to discharge
- The scope of the insider trading provisions was limited

Regulatory regime – SA

- Because s233 failed to arrest rampant insider trading, it was repealed and replaced with section 440F, Amendment Act 69 of 1990
- Section 440F provided as follows:
  - *Any person who, whether directly or indirectly, knowingly deals in a security on the basis of unpublished price-sensitive information, shall be guilty of an offence if the information has been obtained by virtue of a relationship of trust or other contractual relationship or through espionage, theft, bribery, fraud, misrepresentation or other wrongful method, irrespective of the nature thereof*
- s440F widened the scope of insider trading and addressed a majority of the shortcomings of s233
- Securities Regulation Panel appointed to police insider trading
- s440F while an improvement, remained insufficient

A Critical Assessment of the regime





Developments – SA

- Insider Trading Act, 1998 repealed & replaced the inadequate provisions of the Companies Act, 1973 (came into effect in 1999)
- Established Insider Trading Directorate
- There remained gaps in legislation, rendering the policing of insider trading INADEQUATE/INEFFECTIVE
- 2000 – JSE Listings Requirements introduced provisions on directors' dealing
- 2004 – JSE Listings Requirements bolstered with new provisions to counter insider trading
- Securities Services Act, 2004 repealed & replaced the Insider Trading Act, 1998

Insider Trading Regime – UK / EU

- Prohibition on insider trading introduced in Part V, Companies Act, 1980
- Consolidated in the Company Securities (Insider Dealing) Act, 1985
- European Community of Directive 89/592 had the effect of co-ordinating regulations on insider trading across EEC States – laid down minimum standards
- UK updated legislation - Part V, Criminal Justice Act, 1993 ('CJA')
- Legislation established the principle that trading on public markets whilst in the possession of price sensitive, non-public information is unlawful
- Detection and prosecution of those engaged in insider trading remained a problem
- Adoption of the Financial Services and Markets Act, 2000 ('FSMA')

The migration to a market abuse regime

- One of the most important changes introduced by FSMA was the creation of a market abuse regime
- Sections 118 to 137 (Part VIII) of FSMA set out the market abuse regime
- The market abuse provisions supplemented the existing offences of insider trading (Part V, CJA) and making false statements or engaging in false conduct (Section 47, Financial Services Act, 1986) which were narrow in application
- The new market abuse provisions relied on a lower standard of proof for a successful prosecution
- Financial Services Authority ('FSA') appointed to enforce the provisions of FSMA

Market abuse explored

- Market abuse regime aimed not just at criminal behaviour, but at behaviour which undermines confidence in the market and which falls below reasonably expected standards
- FSA required to issue a Code to provide guidance on what behaviour amounts to market abuse

The Regulatory Offence of Market Abuse -UK

- There are seven types of behaviour defined as forms of market abuse:
- Seven types of market abuse:

  - *Insider dealing/ trading*
  - *Improper disclosure of insider information*
  - *Misuse of information*
  - *Manipulating transactions*
  - *Manipulating devices*
  - *Disseminating information likely to give a false or misleading impression*
  - *Market distortion*

The Regulatory Offence of Market Abuse –UK

- Penalties include:
  - *Imposition of an unlimited civil fine*
  - *Public censure*
  - *Restitution of profit made/losses avoided*
  - *The payment of compensation to victims*
  - *Injunction/freezing order*

The Criminal Law - UK

- A person who engages in market abuse may be found to be in breach of the criminal law
- Three prohibited activities (criminal offences) relating to market abuse include the following:

  - *Insider trading (Part V, CJA)*
  - *Misleading statements (s397, FSMA) formerly s47, FS Act*
  - *Market manipulation (s397, FSMA)*

- FSA empowered to take action

Safe Harbours (Defences) - UK

- Defences available to these charged with insider trading include the following:
  - *That no advantage was gained*
  - *That a person would have traded even if he/she was not in possession of inside information*
  - *That the person believed that the information had been widely disclosed*
- CJA contains additional ‘special defences’

Regulatory update - SA

- UK influence evident as SA strengthened securities regulation in 2004
- Securities Services Act (SSA), 2004 adopted, which repealed among others, the Insider Trading Act, 1998
- SSA introduced a consolidated market abuse regime for SA
- SSA outlined four offences constituting market abuse:

  - *Insider trading*
  - *The publication of inside information*
  - *Engaging in a prohibited trading practice*
  - *Misleading or deceptive statements, promises or forecasts*

- Directorate of Market Abuse established
- Penalties increased

What is the Position Today ?

UK/EU

- Market Abuse Directive, 2005 ('MAD') in force across EU
- Amendments to FSMA in 2005

SA

- *Post* the global financial crisis, the SSA was subjected to a comprehensive review to determine if it was still meeting its objectives and if it was aligned to global standards
- The Financial Markets Bill [2010] has been released for public comment

Global Trends

US

- There has been a steady erosion of privacy in the aggressive pursuit of insider trading offences
- Extreme measures resorted to include:
  - *Secretly recorded telephone conversations*
  - *Hacking into e-mail and social network accounts*
- Cases of interest include:
  - *Galleon case (Raj Rajaratnam) – Defendant alleged to have masterminded an insider trading ring that netted his firm $45 million*
  - *Martha Stewart case – CEO of Imclone was accused of avoiding losses of $51 000 by selling shares the day before the stock tumbled after regulators rejected the company's application for a key cancer drug*
- Convictions secured in both cases and many more to date

US

- The Securities Exchange Commission have ‘loosened’ the manipulation standard, enabling the regulator to extract large settlements from defendants
- Insider trading pursued against a wider group of persons including hedge fund and commodity producers
- M&A lawyer and a trader were recently charged with masterminding an insider trading scheme that reaped $32 million by stealing deal information from three corporate law firms

UK


FSA have invested heavily in investigation and enforcement
During 2010, FSA is reported to have issued fines totalling £89.3 million (compared to £35 million in 2009)
Have secured 5 convictions, including the first ever prosecution of an active banker
Galleon case has boosted regulators globally

Have we gone too far?

- International trends indicate an encroachment on civil liberties for insider trading using methods previously reserved for organised crime terrorism and large scale drug dealing
- Which way should SA go?
- Would international for reaching measures to combat insider trading be permissible in our constitutional democracy?

Regulatory regime - SA

- SA appears to be maintaining the delicate balance between enforcing the prohibition and guarding against a trampling of hard won civil liberties
- Financial Markets Bill does not alter existing situation

Practical Issues in monitoring:

- Companies to create restricted lists and observe ‘ closed period’
- Adhere to ethical codes incl. UK Bribery Act
- Training for directors / continual awareness of regulatory landscape
- Stay abreast of developments on international stage

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Questions?

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