ISSN: 1597-7560

VOLUME 4 NUMBER 1 & 2 2009

INTERNATIONAL Journal of LAW & Contemporary Studies

INTERNATIONAL JOURNAL OF LAW AND CONTEMPORARY STUDIES

Volume 4 Number 1 & 2 2009

AIMS AND SCOPE

International Journal of Law and Contemporary Studies is published bi-annually by Development Universal Consortia. It seeks to expand knowledge of inter-relationship between society and development, and serves as a forum for the discussion of Law and Justice, contemporary and emerging issues of Politics, Governance, Security, Democracy, Social and Policy. It is a multi-disciplinary journal, global in nature, integrative in approach, policy oriented and has meet the international indexation standard and acceptability.

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ISSN: 1597 - 7560

INTERNATIONAL JOURNAL

OF

LAW

AND

CONTEMPORARY STUDIES

VOLUME 4
NUMBER 1 & 2
2009

ISSN: 1597 - 7560

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REGULATING INSIDER DEALING: THE NIGERIAN EXPERIENCE

LOKULO-SODIPE, JADESOLA O.

INTRODUCTION

Insider dealing[1] is the use of unpublished price sensitive information to maximize gains or minimize losses on the market. Gower, in his Principle of Modern Company Law[2] defines Insider Trading as "trading in securities whilst in possession of price sensitive information which is not available to the person with whom one is contracting (in face to face transaction) or to other participants in the securities markets (in the case of a transaction on an exchange) at the relevant time. Insider dealing may also be defined as the purchase or sale of securities in breach of a fiduciary duty or other relationship of trust and confidence, by persons who have access to material information that is not available to those with whom they deal or to traders generally. Section 264 of the Investment and Securities Act[3] provides that insider dealing occurs where a person or group of persons who are in possession of some confidential and price sensitive information not generally available to the public, utilizes such information to buy or sell securities for the benefit of himself or any person.

Going by these definitions, there would be a violation of the law, where the information is: (i) unpublished, therefore not available to the general public, (ii) price sensitive and of material value, (iii) taken advantage of on the stock market to make a profit or reduce loss.

Inside information could be made use of directly by the person who has access to such information or passed on to another person (tippee) who takes advantage of the information to deal on the securities of the company in question. The original source of the information may or may not be aware that the party will use the information which was innocently or otherwise passed on to him. Consequently, an instance would be, where a top executive of a company went to his barber to have a haircut and there he met a friend and in the course of conversation, he innocently revealed certain material information about an impending development in his company. Unknown to him, the barber heard and later approached his (barber's) stockbroker to purchase the company's

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securities on his behalf, knowing that the value of the securities would appreciate when the impending development is made public. Then he would sell and make huge profits.

There is a true story[4] of the wife of a chief executive officer of a United States company who in the process of undergoing a psychiatric treatment in 1981 disclosed to psychiatrist impending merger between Shearson Loeb Rhodes (where her husband was the chief executive officer) and American Express. The psychiatrist took advantage of the information and bought Shearson's securities. Later in 1986, the same lady, still receiving treatment, disclosed to the same psychiatrist that her husband, after leaving American Express, was likely to take up the chief executive position in Bank of America and would inject significant capital into the company. Again the psychiatrist took advantage of the information, buying Bank of America's stock to the tune of USD 171,130. When the patient's husband eventually made his intentions public, Bank of America's shares soared and the psychiatrist made a profit of USD 27,475 in 40 days. The psychiatrist was penalized by being asked to refund the profit of USD 27,475 in addition to USD 109, 10395[5] .

The essence of the foregoing is to highlight how persons in possession of key corporate information do at times unwittingly disclose vital unpublished information to others who might use such information. Care is therefore required from all persons with access to unpublished price sensitive information such to third parties.

This study examines the various aspects of Insider Dealing and Legal and Regulatory Provisions on Insider Dealing. It traces the origin of Insider Dealing regulations. The various aspects to be discussed includes, what amounts to 'inside information', who is an 'insider', the criminal and civil aspects of Insider Dealing and the various Legal and Regulatory Provisions. It will discuss the extent to which the regulations have been put into use in Nigeria.

INSIDER DEALING REGULATIONS

Insider dealing can be defined as the use of unpublished price sensitive information to maximize gains or minimize losses on the stock market. Inside information could be made use of directly by the person who has access to such information or passed on to another person (tippee) who takes advantage of the information to deal on the securities of the company.

Under the provisions of the Investment and Securities Act (ISA) 2004, insider dealing becomes in certain circumstances a criminal offence. These provisions supplement the equitable rules relating to directors' fiduciary duties, the prohibition on options dealings and the provisions on take-overs and mergers.

The ISA prohibits insider dealing, as defined. Insider dealing would usually be done through a recognized stock exchange or through off – market dealings by an

individual who is connected with the company in question, a public officer, a take-over bidder or an individual who has obtained information on them.

The ISA also prohibits the counseling or procuring of dealing or the communication of information by these individuals. Bodies corporate as such are excluded from the prohibition. In Attorney General's Reference No 1 of 1988[6], "Lord Lane described the rationale behind the prohibition 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 profit on their dealing with others".*

Although, the United States of America appears to be in the fore-front of the attack on insider trading, effective regulation commenced with the passing of Securities Act 1933 and the Securities and Exchange Act 1934.

Interestingly, these statues do not expressly define or prohibit Insider Trading. With regards the offence of insider dealing the United States Securities and Exchange Commission (USSEC) relies on the provisions of S.16 of the Securities and Exchange (SEC) Act 1934. Section 16(A) of the Sec Act 1934 requires monthly disclosure of holdings and transactions of directors and officers who own more than 10% of the equity capital of corporation. Section 16 (B) is an attempt to prevent "unfair use" of information by insiders. Profits from such illegal transactions are to be refunded to the company within a period of not less than 6 months.

Section 10 (B) under which Rule 10b-5 is derived, is an attempt to generally prevent manipulative and other fraudulent practices in the securities market. It gives the USSEC powers to formulate rules and regulations, as it deems "necessary or appropriate in the public interest or for the protection of investors". Rule 10 b-5 forms the basis of most Insider Dealing cases in the US.' This rule specifically prohibits the use of manipulative and deceptive, devices, misstatements, omission to state a material fact or engagement "in any act, practices or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security". Rule 14 e-3 prohibits insider dealing with respect to tender offers. Violators of Rule 10b-5 face both implied civil actions and express statutory sanctions, court action for injunction by the USSEC, criminal prosecution, administrative discipline for brokers or dealers, equity relief of disgorgement of ill-gotten gains and damages for private actions.

In the United Kingdom, there had been cases of Insider Dealings, as far back as the 1700s. One of these led to the Southsea Bubble burst of 1720 and the subsequent passage of the Bubble Act in Sept. 1720. The City Panel on Takeovers and Mergers as well as the International Stock Exchange in the United Kingdom requires certain

disclosures aimed principally at preventing insider trading. The main statutory provisions against insider trading can be found in Part V of the Companies Act 1980. With the consolidation of statutory company law, the provisions on insider dealing in the 1980 Act were re-enacted in the Company Securities (Insider Dealing) Act 1985[7], and sections 173-178 of the Financial Services Act 1986.

The provisions of the 1985 Act focused mainly on punishing misuse of unpublished information acquired in confidence from a company which would affect the price of that company's securities if the information were made public[8].

Prior to the enactment of the Companies Act 1980, insider dealing was not a criminal offence under the British laws. The complexity and difficulty in obtaining convictions under the Act[9] and the need to implement the E.C Directive [89/592/EEC][10], led to the replacement of the 1985 Act by Part V of the Criminal Justice Act 1993[11].

This new law concentrated more on the control of the securities markets than on the abuse of confidential information. The Criminal Justice Act 1993 makes provisions only for criminal sanctions for insider dealing.

ORIGIN OF INSIDER DEALING REGULATION

Until recently, that when a person traded in securities on the basis of privilege information, he was generally regarded as not having done anything which merited punishment. As a matter of fact, at common law, no clear prohibition was imposed on the use of inside information except in the case of industrial and trade secrets and details concerning customers[12].

Thus, a company director who had inside information about something which, when publicly known, would cause the price of his shares to rise might himself take advantage of that information and buy the shares cheap. Likewise, a person who had a professional relationship with that company and had inside information might do the same. Recently, changes in the conception of business morality and transparency have been evolving because of the danger which unrestricted use of insider knowledge can cause to dealings in company securities.

The realization that, in order to preserve and promote integrity of the market, it was necessary to preserve confidential information led to steps being taken to check insider dealing.

The term Insider Dealing, found its first legal expression in the decision of the United State Securities And Exchange Commission (USSEC) in 1961. In *Re Cady Roberts & Co*[13], the USSEC gave an illustration of what is involved in Insider Dealing. The facts are as follows, a broker had used inside information about a company's dividend, which he received from a fellow employee who was a director of that company. He was held liable for insider dealing. The chairman at the administrative proceedings observed as follows,

> *"....first, the existence of a relationship giving access (directly), to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing".*

Consequently, anyone who trades for his own account in the securities of a corporation and has access directly or indirectly to information which is intended to be made available only for a corporate purpose and not for the personal benefit of anyone, and trades on the basis of that information, knowing it is unavailable to those with whom he is dealing is guilty of Insider Dealing.

REGULATING INSIDER DEALING IN NIGERIA

The statutory environment in Nigeria combines the approaches in the United States and Britain. The Securities and Exchange Commission Act (cap 406) 1990 empowers the Securities and Exchange Commission (SEC) to protect the integrity of the securities market against any abuse arising from the practice of insider dealing[14].

Pursuant to that power, SEC, adopted in the Rules and Regulations made pursuant to the Act, a set of rules very akin to the US Rule 10b-5. Regulation 7 generally prohibits frauds or misstatements or half-truths by any person trading in securities of a company on which he is an insider.

The first statutory provision which made insider dealing an offence was the Companies and Allied Matters Act (CAMA) 1990[15]. However, the SEC Act and Part XVII of the CAMA 1990 have been repealed by the Investment and Securities Act (ISA) 2004[16]. Provisions for the offence of insider dealing are contained in sections 88-89 of the ISA.

Section 264 ISA defines insider dealing as a transaction which

> *"occurs where a person or group of persons who are in possession of some confidential and price sensitive information utilizes such information to buy or sell securities for his/its own account and for his benefit or makes such information available to the third party (either knowingly or unknowingly) who uses it for his benefit".*

WHY REGULATE INSIDER DEALING?

It has been argued that insider dealing is positively beneficial in that it brings information swiftly to the securities market and that no one actually losses, in that the insider does not make a gain at anyone's expense[17]. Be that as it may, certain key

elements must be present in ensuring the stability of the capital market. These include: (i) confidence by the populace in the market, (ii) unrestricted and easy flow of information available to the market at the same time, (iii) absence of manipulative or deceptive dealing.

Consequently the law prohibiting insider dealing can be supported on 2 broad grounds, namely: (i) that confidence must be maintain, (ii) that confidential information need to be secured.

The activities of insiders generally eroding the confidence in the market and therefore threatens the stability of the capital market and indeed the financial system. One may then ask, "How do the activities of insiders erode confidence in the market?

Their fraudulent activities erode the confidence in the market, in that they take advantage of restricted information not known to others to make quick profit or minimize their losses. By so doing, other players in the market are placed at a disadvantage. For instance, if a substantial shareholder decides to sell his holdings as a result of some information, the prices of the company's shares are likely to drop. This in essence means that the value of the company and the value of holdings of other shareholders have declined. Any shareholder who sells at this time would most likely incur a loss.

The awareness of investors that prices of securities do not reflect their true value can discourage participation. The market must be seen to be fair and devoid of manipulative dealings if it must grow. Deceptive, manipulative and inside dealings destroy confidence in the market. This will be inimical to the economy of a developing nation like Nigeria.

Having examined the need to regulate insider dealing, the next step is to determine who is an insider and what constitutes inside information.

INSIDER

The following categories of persons can be classified as insiders:

(1) An individual who is or at any time in the preceding 6 months has been knowingly connected with the company[18], in any of the under listed capacities; and who has information which he knows is unpublished price sensitive information in relation to securities of the company[19]. Consequently, an individual is connected with a company if: (i) a director of the company or a related company, (ii) an officer of the company other than a director or a related company, (iii) an employee of the company or a related company, (iv) a person in a position, involving a professional or business relationship with the company as above, (v) a share holder who owns 5% or more of any class of securities or any person who can be deemed to be an agent of any of above listed person; and

(2) An individual who is, or at any time in the preceding 6 months has been knowingly connected with a company and has inside information in relation to another company's securities[20].

(3) An individual who is contemplating or has contemplated making (with or without another person) a takeover offer or the fact that the offer is no longer contemplated is unpublished price sensitive information[21]. Consequently, insiders would include directors and top management staff, issuing house staff, professionals such as auditors, lawyers, accountants as well as substantial shareholders. Tippees[22] have also been treated as insiders. They include other people benefiting from the insider information. There may be instances where a trader would use information not available to the public though his source is not the issuer of the securities.

This situation is covered by S.89 ISA which prohibits the buying and selling or otherwise dealing in the securities of a company on the basis of information which is held by a public officer or former public officer by virtue of his position or former position as a public officer, or which is knowingly obtained by an individual (directly or indirectly) from a public officer or a former public officer who he knows or has reasonable cause to believe that he held the information by virtue of any such position.

The obligation not to disclose information is connected to the issue of the securities in question. Therefore, the source of the insider information must be connected to the company whose securities are involved.

INSIDE INFORMATION

S.88 (1) ISA 2004 gives a description of what amounts to inside information. Inside information, according to the subsection is unpublished price sensitive information in relation to "the securities in question".

Consequently/inside information is material[23], non-public information that is, information which is not generally available to the investing public. The "unpublished price sensitive" information should:

(i) be in respect of specific matters relating to or of concern (directly or indirectly) to the relevant company.

(ii) not be generally known to those persons who are accustomed to or would likely deal in the relevant securities, and

(iii) would if it were generally known to them, be likely to have a significant effect on the price or value of these securities.

Consequently, the important question is, "if the inside information is placed in the market place along with the information mix about the securities which is already there, will it then affect the price?"

Another question is, 'when does information become "generally" available?' The answer cannot refer simply to the time when a release is handed to the press. Just because the price sensitive information has been released publicly by an announcement does not deny an advantage to an insider who trades immediately because the market

will not immediately accommodate the information and therefore the price would not have adjusted accordingly. In fact, at the point of release, the information will not generally be known to those people who are accustomed or would be likely to deal.

The USSEC treats this issue as one of fact depending on all circumstances. The ISA 2004 is silent on this issue and in view of the fact that there has been no prosecuted case on insider dealing, it is not known when information would be deemed to be "generally" available. It is however safe, to suggest that the case - by - case approach used by the USSEC be adopted.

ELEMENTS OF OFFENCE OF INSIDER TRADING

Insider trading may be classified into 2, namely:

(i) Primary Insider trading which occurs when an individual himself deals in the securities he is prohibited from dealing in.

(ii) Secondary Insider trading is where another person (Tippee) who receives inside information deals in the securities which the insider is prohibited from dealing in.

Section 88 ISA 2004 prohibits insiders from dealing in securities of the company in which they are directly connected, if, by virtue of that connection they possess unpublished price sensitive information about the company[24]. This section also prohibits tippees from making use of inside information sourced directly or indirectly from insiders of a company or related company[25],[26].

ABUSE OF INFORMATION OBTAINED IN OFFICIAL CAPACITY[27]

This applies to any information which is held by a public officer or former public officer by virtue of his position or former position as a public officer. Such public officer shall not deal in any relevant securities nor counsel or procure any other person to deal in any such securities, knowingly or having reasonable cause to believe that any other person would deal in such securities or communicate to any person the information held or (as the case may be) obtained in his capacity as a public officer if he knows or has reasonable cause to believe that he or some other person will make use of the information for the purpose of dealing or of counseling or procuring any other person to deal on a securities exchange or capital trade point in any such securities.

Also prohibited from the use of inside information are those who are contemplating or have contemplated takeover[28]. An individual who in prohibited under section.88 (1) - (5) from dealing on an approved Securities Exchange or Capital Trade Point commits an offence if he counsels or procures another person to so deal[29]. Section 88 (7) prohibits an individual who is prohibited from dealing in any securities by reason of his having any information from communicating that information to any other person if he

knows or has reasonable cause to believe that other person will make use of the information for the purpose of dealing or of counseling or procuring another person to deal in the securities. Section 89 includes public officers and former public officers. It prohibits the abuse of information obtained in their official capacity. A public officer or former public officer may not counsel or procure another person to deal in the securities he is prohibited from dealing in[30]. He is also prohibited from communicating any inside information to another for the purpose of dealing in such securities[31].

An individual is exempted from the provisions of SS.88 & 89 if he uses the information for the following purposes: (a) doing any particular thing otherwise than that with a view to making of a profit or the avoidance of a loss, (b) entering into a transaction in the course of the exercise in good faith of his functions as a liquidator, receiver or trustee or bankruptcy, (c) doing any particular thing if the information, (i) was obtained by him in the course of a business of a stockbroker in which he was engaged or employed; (ii) was such that it would be reasonable to expect him to obtain in the ordinary course of business.

On the quantum of required disclosure, the test is the materiality of the information. The burden of proof in an insider dealing action is on prosecution and the standard of proof (as in all criminal cases) is proof beyond reasonable doubt[32].

The ISA 2004 provides sanctions for violation of inside information by insiders as well as serving and former public officers. S. 94 imposes a criminal liability and makes provisions for penalties which include a prison term not exceeding 2 years or payment of a fine of N1 000 000 (one million Naira). S.93 provides for civil liabilities. These include: (a) compensation by Insider/Tippee for any direct loss suffered as a result of the transaction[33]. (b)such insider will be accountable to the company for the direct benefit or advantage received or receivable by the insider[34].

There is a 2 years limitation period from date of transaction on when an action may be instituted against an insider[35].

DEFENCES[36]

An Insider by reason of his having any information would not be prohibited from

(i) Using the information in such a way as not to earn either him or another person a profit.
(ii) Entering into a transaction (in good faith) in the course of acting as a liquidator, receiver, or trustee in bankruptcy.
(iii) Using the information he obtained as a stockbroker and would be expected to obtain in the ordinary course of business, in good faith.
(iv) Using the information to facilitate the completion or carrying out of a transaction.

EFFECT OF INSIDER TRADING ON A TRANSACTION

Section.92 ISA 2004 provides that any transaction entered into in contravention of section 88 or Section 89 will either be void or voidable. Consequently, a transaction by an insider or a tippee may be upheld. It will only at best earn compensation.

CIVIL ASPECT OF INSIDER TRADING

There is also a civil aspect to insider dealing. This is based on fiduciary duty[37]. Insiders abuse the trust and confidence reposed in them because they make use of price sensitive formation held by them for their own advantage or personal gains.

As noted earlier, chief executive officers, directors and top management staff are vulnerable to insider dealing. These groups of people stand in a fiduciary position to their companies. Consequently, if they use information obtained by virtue of their position, to make profit for themselves, they will be in breach of that fiduciary duty and will be liable to disclose and be accountable to the company for all profit made in such transaction(s).

By virtue of the provisions of Section.93 ISA 2004, an insider who contravenes the provisions of sections 88 & 89 ISA 2004, will, on conviction, compensate any person for any direct loss suffered by that person as a result of the transaction as well as being accountable to the company for the direct benefit or advice receive or receivable by the insider as a result of the transaction.

CONCLUDING REMARKS

There is no doubt that the illegal activities of insiders can affect the stability of any capital market for this reason, many governments of both developed and developing economies have outlawed insider dealing and provided stiff sanctions for violators. The Nigerian government has followed suit. The provisions on the insider dealing were contained in the SEC Decree 1988 and CAMA 1990. These have been repealed with the promulgation of the ISA 2004.

The ISA 2004 is an improvement on provisions on Insider dealing. The ISA has among others broadened the scope of offences emanating from insider dealing and the penalty has been increased to reflect the profit which can be made from insider dealing transaction. It is therefore safe to say that the ISA 2004 contains ample provision which can be employed to deal effectively with insider dealing. Be that as it may, the sanctions imposed by the ISA 2004, are lenient compared to those in the UK where an alleged insider dealer faces up to 7 years imprisonment and in the US where a fine of up to three times of the profit made can be adequate.

Insider dealing has been described as the victimless and conviction less crime[38]. This is because no one suffers direct personal loss neither does it leave obvious trail of

evidence as other crimes. These characteristics of insider dealing have made it difficult to successfully bring offenders to book. In Nigeria, even though the law regulating insider dealing has been in place for almost 20 years[39], there has been no prosecution. That is not to say that insider dealing is non-existent in Nigeria.

It is the opinion of this writer that, this relates to the problem of enforcement. It is a known fact that Nigeria has a problem of law enforcement. This is coupled with the fact that most Nigerians either are not aware of their rights or are not willing to pursue them.

However, with public enlightenment, investors who are affected by this crime would seize the opportunity available by reporting the offences to the appropriate authority, rather than treating them as "sacred cows".

It is hoped that the relevant authorities will do more to prosecute offenders. The SEC has wide powers[40] to regulate investments and securities business in Nigeria and to maintain market integrity. It should therefore enforce these powers through close monitoring of the activities of the exchanges and the market participants with a view to detect sharp practices and prosecuting offenders as the case may be.

It is the submission of the writer that a weak enforcement of the provisions of securities laws would result in a weak regulating environment and undermined capital market.

NOTES

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[1] The words insider dealing and insider trading are used interchangeably.

[2] **Davies P. L**.(ed), Gower's Principles of Modern Company Law., (1997)., Sweet and Maxwell., p.43.

[3] Cap I24 Laws of the Federation of Nigeria 2004.

[4] See "Euromoney", Feb, 1991.

[5] The psychiatrist was inter alia penalized under the Insider Trading Sanctions Act 1984, which gives the US Securities and Exchange Commission powers to institute penalties of up to three times of the profit generated from trading on inside information.

[6] (1989) 2 All E.R. 1.

[7] This was amended primarily, by the Financial Services Act 1986.

[8] **Mason S**; **French D**; **Ryan C**, Company Law; (14th ed)., Blackstone Press., Lond. 1977, p.343.

[9] Palmer's Company Law, Vol.2., Sweet and Maxwell, 1994., p.1042; See also "Rush of Insider dealing cases in UK", published in Legalbrief Today, retrieved from

www.legalbrief.co.za on 18/2/09. Where Tom Epps, a business crime lawyer while commenting on the series of cases emanating from an allegation of insider dealing against a former senior executive and his co- accused noted that "criminal insider dealing cases are very rare in the UK and so to have 5 under way simultaneously is a watershed moment in the prosecution of financial crime"

[10] See gov/litigation/litreleases/2008/lr20603.htm. retrieved on 20th Nov, 2008.

[11] See Sections 52-64.

[12] *Measures Brothers .v Measures* (1910) Ch 3; *Cranleigh Precision Engineering v. Bryant* (1965) 1 WLR 1293.

[13] 40 SEC 90.

[14] See Section 6.

[15] See Sections 614-621 CAMA 1990.

[16] See Section 263 ISA 2004.

[17] **Manne H**, Insider Trading and the Stock Market. The Free Press, New York.,1966.

[18] See section 95(2) (a) ISA 2004.

[19] Section 88(1) ISA 2004.

[20] Section 95(2) ISA 2004.

[21] Section 88 (1) ISA 2004.

[22] A tippee is a receiver of inside information.

[23] A fact is material if there is substantial likelihood that a reasonable person would consider it important under the circumstances in determining his course of action.

[24] Section 81(1) ISA 2004.

[25] Section 88(2) ISA 2004.

[26] Section 95(1) ISA defines 'related company' as any body corporate which is a company's subsidiary or a holding company or a subsidiary of a holding company.

[27] See Section 89 ISA 2004 generally.

[28] Section 88(4),(5) ISA 2004.

[29] Section 88(6) ISA 2004.

[30] Section 89(3)(b) ISA 2004.

[31] Section 83(3)(c) ISA 2004.

[32] *Woolmington .v. DPP* (1935) AC 462.

[33] Section 93(a) ISA 2004.

[34] Section 93(1)(b) ISA 2004.

[35] Section 93(2) ISA 2004.

[36] Section 90(1)ISA 2004.

[37] Section 279 CAMA 2004 for the duties of a director.

[38] **Ashe M, Counsel L**.Insider Trading., (1993), Trolley Publishing Co., Surrey, UK.

[39] See SEC Decree 1988 and Rules and Regulations made pursuant to it.

[40] See ISA 2004 generally.