The Inherent Challenges in the South African Anti-Market Abuse Enforcement Framework in Relation to Selected Market Abuse Practices that Occurred During the Global Financial Crisis

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Abstract

The article discusses selected market abuse activities that manifested in several financial markets during the recent global financial crisis. In relation to this, market abuse activities such as front running and quote stuffing, dark pools and flash orders, hedge funds insider trading and high yield securities investment fraud, high frequency trading, credit default swaps and short selling will be briefly analysed. This is done to investigate whether the current South African anti-market abuse enforcement framework is robust enough to effectively combat these activities. This is further aimed at exposing certain challenges embedded in the South African anti-market abuse enforcement framework in relation to the prevention and combating of the aforementioned practices in the financial markets in South Africa. To this end, the article seeks to explore these challenges by, first, examining the adequacy of the South African anti-market abuse enforcement framework with regard to the combating of front running and quote stuffing. Secondly, the adequacy of the South African anti-market abuse enforcement framework with regard to the curbing of dark pools and flash orders will be discussed. Thirdly, the adequacy of the aforesaid enforcement framework will be examined in relation to the combating of hedge funds insider trading and high yield securities investment fraud. Fourthly, a similar examination will be done in respect of high frequency trading. Fifthly, the adequacy of the South African anti-market abuse enforcement framework with regard to the curbing of credit default swaps will be discussed. Lastly, a similar discussion regarding short selling will be undertaken.

Keywords: *Market Abuse, Front Running, Dark Pools, Short Selling, Credit Default Swaps.*

1. Introduction

For the purposes of this article, the term “market abuse” is used as a generic term referring to both insider trading and market manipulation.[1] In relation to this, it is also important to note that the regulation and enforcement of market abuse laws has been controversial[2] and inconsistently applied in many jurisdictions,[3] including South Africa.[4] It is against this background that this article discusses selected market abuse activities that manifested in several financial markets during the recent global financial crisis. In this regard, market abuse activities such as front running and quote stuffing, dark pools and flash orders, hedge funds insider trading and high yield securities investment fraud, high frequency trading, credit default swaps and short selling will be briefly analysed. This is done to investigate whether the current South African anti-market abuse enforcement framework is robust enough to effectively combat these activities.[5] This is further

[1]Notably, these practices and other related activities were more negatively manifested during the recent 2007 to 2009 global financial crisis.
[2]See further Fischel & Ross “Should the Law Prohibit ‘Market Manipulation’ in Financial Markets” 1991 Harvard Law Review 503 506.
[3]See Bhattacharya & Daouk “The World Price of Insider Trading” 2002 Journal of Finance 75 75-108; Lyon & Du Plessis The Law of Insider Trading in Australia (2005) 159-168 for related comparative analysis in other countries & Avgouleas The Mechanics and Regulation of Market Abuse: A legal and Economic Analysis (2005) 75-502.
[4]Osode “The new South African Insider Trading Act: Sound law reform or legislative overkill?” 2000 Journal of African Law 239 239; Bhana “Take-Over Announcements and Insider Trading Activity on the Johannesburg Stock Exchange” 1987 South African Journal of Business Management 198-208; Jooste “A critique of the insider trading provisions of the 2004 Securities Services Act” 2006 SALJ 437 441–460; Van Deventer “New watchdog for insider trading” 1999 FSB Bulletin 2 3; the King Task Group into Insider Trading Legislation Minority Report on Insider Trading 1997 para 3.4 as summarised in Beuthin & Luiz Beuthin’s Basic Company Law (2000) 235–238; the Van Wyk de Vries Commission of Inquiry into the Companies Act of 1973.
[5] Chitimira A Comparative Analysis of the Enforcement of Market Abuse Provisions (2012) LLD thesis, Nelson Mandela Metropolitan University, 167-187. Also see Botha “Control of Insider Trading in South Africa: A Comparative Analysis” 1991 SA Merc LJ 1-18; Botha “Increased Maximum Fine for Insider Trading: A Realistic and Effective Deterrent?” 1990 SALJ 504-508; Chitimira The Regulation of Insider Trading in South Africa: A Roadmap for an Effective, Competitive and Adequate Regulatory Statutory Framework (2008) LLM dissertation, University of Fort Hare, 41–72. See related comments by Van Deventer “Anti-Market Abuse Legislation in South Africa” (10-06-2008) 1-5 <http://www.fsb.co.za/public/marketabuse/FSBReport.pdf> (accessed 05-05-2013) & see further Myburgh & Davis “The Impact of South Africa’s Insider Trading Regime: A Report for the Financial Services Board” (25-03-2004) 8-33 <http://www.genesis-analytics.com/public/FSBReport.pdf> (accessed 09-02-2013). Notwithstanding the fact that this Myburgh & Davis report was published in 2004 before the Securities Services Act 36 of 2004, hereinafter referred to as the Securities Services Act, came into effect and the fact that it was

aimed at exposing certain challenges embedded in the South African anti-market abuse enforcement framework in relation to the prevention and combating of the aforementioned practices in the financial markets in South Africa.[6] To this end, the article seeks to explore these challenges by, first, examining the adequacy of the South African anti-market abuse enforcement framework with regard to the combating of front running and quote stuffing. Secondly, the adequacy of the South African anti-market abuse enforcement framework with regard to the curbing of dark pools and flash orders will be discussed. Thirdly, the adequacy of the aforesaid enforcement framework will be examined in relation to the combating of hedge funds insider trading and high yield securities investment fraud. Fourthly, a similar examination will be done in respect of high frequency trading. Fifthly, the adequacy of the South African anti-market abuse enforcement framework with regard to the curbing of credit default swaps will be discussed. Lastly, a similar discussion regarding short selling will be undertaken.

2. The Challenges in the Current Market Abuse Enforcement Framework in Relation to Selected Market Abuse Practices that Occurred During the Global Financial Crisis

The regulation and enforcement of the market abuse ban in relation to some selected market abuse practices that manifested during the recent global financial crisis[7] will be briefly examined below to investigate whether the current South African anti-market abuse enforcement framework is robust enough to combat such practices in South Africa.

2.1 Front Running and Quote Stuffing

Front running is a technique employed by market participants like brokers to anticipate the effect and/or impact of upcoming trading transactions on the price of certain securities.[8] Although illegal front running is outlawed in both the United States of America ("the US") and the United Kingdom ("the UK"), it became more prevalent in their financial markets during the global financial crisis.[9] Some persons took advantage of fact that front running is not always illegal to engage in market manipulation by buying stock just before large institutional stock orders caused a quick increase in the prices of that stock.[10] Prohibition on illegal front running was difficult to enforce in the US while such prohibition was implemented fairly in the UK by the Financial Services Authority ("the FSA") which investigated and arrested about seven persons for allegedly perpetrating unlawful front running activities during the global financial crisis.[11] In the UK, illegal front running by brokerage companies, fund managers and financial analysts or advisors who were privy to non-public inside information was strictly outlawed and these key market participants were required to get permission from the FSA's Compliance Department before they buy stock for their own account.[12]

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somewhat influenced by the opinions of the interviewees, it shall be referred to in this article where necessary, not as the only basis or evidence of the existence of market abuse activity in the South African financial markets but as a pointer on how market abuse laws were enforced in South Africa prior to the enactment of the Financial Markets Act 19 of 2012, hereinafter referred to as the Financial Markets Act, which came into effect on 03 June 2013. Notably, the Securities Services Act has now been repealed and will only be referred to where necessary for historical comparative purposes. Moreover, the Myburgh & Davis report and a few other selected and available sources will be referred to throughout this article because there are currently very few new sources on the enforcement of the market abuse prohibition in South Africa, especially under the Financial Markets Act.

[6] See further related comments by Van Deventer (10-06-2008) 1–5, available at <http://www.fsb.co.za/public /marketabuse/FSBReport.pdf> (accessed 05-05-2013) & Myburgh & Davis (25-03-2004) 8–33, available at <http://www.genesis-analytics.com/public/FSBReport.pdf> (accessed 09-02-2013). Luiz "Prohibition Against Trading on Inside Information–The Saga Continues" 1990 SA Merc LJ 328 328-332; Luiz "Insider Trading Regulation – If at First You Don't Succeed…" 1999 SA Merc LJ 136 136-151; Jooste "Insider Trading: A New Clamp-Down" 1991 BML 248 248-250; Jooste "Insider Dealing in South Africa–The Criminal Aspects" 1990 De Ratione 21 21-28; Henning & Du Toit "The Regulation of False Trading, Market Manipulation and Insider Trading" 2000 Journal for Juridical Science 155 155-165; Osode "The Regulation of Insider Trading in South Africa: A Public Choice Perspective" 1999 African Journal of International and Comparative Law 688 688-708; Van der Lingen "Tougher Legislation to Combat Insider Trading" 1997 FSB Bulletin 10;Van Zyl "Aspekte van Beleggersbeskerming in die Suid-Afrikaanse Reg" 1992 Transactions of the Center for Business Law 231-357; Chanetsa "Insider Trading is Notoriously Hard to Prosecute" Business Report 26 April 2004; Pretorius and Another v Natal South Sea Investment Trust 1965 3 SA 410 (W), were the courts failed to convict the suspected insider trading offenders.

[7] Notably, the 2007 to 2009 global financial crisis began in the subprime mortgage market (the so-called housing bubble) of the United States of America (US) approximately during the period between 2005 and 2006. See Swart The Legal Framework Pertaining to Selected Segments of the Financial Market LLM Dissertation, Nelson Mandela Metropolitan University (2011) 98; Paulo "Europe and the Global Financial Crisis Explained in 10 Sheets: Taking Stock of the EU's Policy Response" April 2011 Fondation Robert Schuman 3 <http://www.robert-schuman.eu/frs-fichecrisefi-qe200-en.pdf> (accessed 04-07-2013); also see generally related comments by Le Vine & Malgadi "Mortgage Crises, Derivatives and Economic Chaos" (2009) <http://asbbs.org/files/2009/PDF/M/MalgadiA2.pdf> (accessed 17-07-2011) & also see Anonymous "Reason for Global Recession: In Plain Simple English" <http://www.theindianblogger.com /problems/reasons-for-global-recession-in-plain-simple-english> (accessed 07-07-2011).

[8] Anonymous "Front Running" <http://www.wikinvest.com/wikiFront-running.htm> (accessed 04-02-2014).

[9] Anonymous "Front Running" <http://www.wikinvest.com/wikiFront-running.htm> (accessed 04-02-2014).

[10] Anonymous "Front Running" <http://www.wikinvest.com/wikiFront-running.htm> (accessed 04-02-2014).

[11] Anonymous "Front Running" <http://www.wikinvest.com/wikiFront-running.htm> (accessed 04-02-2014).

[12] Anonymous "Front Running" <http://www.wikinvest.com/wikiFront-running.htm> (accessed 04-02-2014).

Quote stuffing is a manipulative tactic which involves the prompt entering and withdrawing of large stock orders by any person in order to flood the market with quotes that other persons have to process, thereby causing them to lose their fair competitive advantage in such stocks.[13] During the global financial crisis, quote stuffing transactions were executed through high frequency trading computerised programs that are capable of distorting and speedily transferring large stocks to the markets. The so-called "flash crash" which occurred in the US's financial markets is a case in point.[14]

2.1.1 Evaluation of the South African Anti-Market Abuse Enforcement Framework

Trade-based market manipulation activities such quote stuffing and front running are not prohibited under the Companies Act.[15] However, these activities are outlawed in the Financial Markets Act.[16] Although this Act does not directly employ the terms "quote stuffing" and "front running", it has similar provisions which discourage these manipulative activities.[17] Nonetheless, it is submitted that this Act should be amended in order to: (a) expressly apply to possible "quote stuffing" and "front running" that might occur in the over the counter commodity and commodity derivatives transactions; and (b) provide a mandatory requirement on the part of the financial analysts or advisors, brokers and other market participants to hold onto their orders openly for specific minimum periods in order not to prejudice investors through quote stuffing or front running.[18] This could enable the Financial Services Board ("the FSB") and the Johannesburg Stock Exchange Limited ("the JSE") to combat quote stuffing and front running in the relevant financial markets in South Africa.

2.2 Dark Pools and Flash Orders

Dark pools involve more than one person colluding to buy or sell a security in a bid to create an artificial market activity. After the global financial crisis, in October 2009, the United States Securities and Exchange Commission ("the SEC") proposed new rules to increase the transparency of dark pools of liquidity and non-public trading interest in the listed stocks by requiring timeous disclosure of actionable indications of interest except when specific conditions relating to large orders that promote size discovery are met.[19] This is targeted at minimising market manipulation of interest indications by privately owned dark pools and selective trading which prejudice other investors.[20] On the other hand, a flash order is a practice that allows a person who has not yet disclosed a stock quote to quickly view other stock orders before the public and other interested persons are given a chance to trade in those stocks.[21] According to Schapiro, flash orders were perpetrated through highly computerised and automated trading devices which gave an unfair advantage to such perpetrators.[22]

2.2.1 Evaluation of the South African Anti-Market Abuse Enforcement Framework

Trade-based market manipulation provisions contained in the Financial Markets Act[23] do not specifically prohibit dark pools and flash orders. Dark pools and flash orders are also not expressly prohibited in the Companies Act 2008. Given

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[13] Lauricella & Strasburg "Quote Stuffing" <http://www.investopedia.com/terms/q/quote-stuffing.asp> (accessed 04-02-2014).
[14] It is reported that the SEC has, after the 06 May 2010 'flash crash' adopted strict measures such as requiring market participants to openly hold-on to their orders for specific minimum periods in order not to prejudice investors and by regulating the use of high frequency trading to engage in quote stuffing especially when large numbers of orders to buy or sell stocks are quickly placed and immediately cancelled thereafter, to prevent the recurrence of the effects of flash orders that contributed to the Dow Jones Industrial Average to tumble by about 700 points within a few minutes on 06 May 2010. See further Lauricella & Strasburg "Quote Stuffing" <http://www.investopedia.com/terms/q/quote-stuffing.asp> (accessed 04-02-2014).
[15] 71 of 2008, hereinafter referred to as the Companies Act 2008.
[16] S 80.
[17] S 80(1); (2) & (3)(b) which prohibits any person from entering an order to buy or sell a listed security while aware that the same or opposite order will be entered by the same or different person to create a false artificial market price of that security. This is similar to front running which is also outlawed in the US & United Kingdom (UK) & also see s 80(3)(e) prohibits the entering of orders to buy or sell a listed security during auction process or pre-opening session and immediate cancellation of such orders to create a false demand and supply of that security in order to gain profit and an affair advantage over other investors. This is similar to quote stuffing which is outlawed in the US & other developed jurisdictions.
[18] See related remarks in paragraph 2.1 above.
[19] It is stated that the new alternative trading systems allows the stock trading volume threshold to display stock orders only between 5% & 0.25%. In relation to this, generally see Anonymous "Part II: What is Meant by Market Manipulation and Should it be Regulated?" (29-11-2005) 6-7 <http://www.med.govnt.nz/templates/MultipageDocumentPage6861.aspx> (accessed 14-01-2014).
[20] See further Schapiro Testimony before the Financial Crisis Inquiry Commission Concerning the State of the Financial Crisis 14 January 2010 21.
[21] Schapiro Testimony before the Financial Crisis Inquiry Commission Concerning the State of the Financial Crisis 14 January 2010 21.
[22] Flash orders led some investors to become sceptical about complying with the SEC's disclosure rules owing to fears that they could fall victim to manipulative flash orders after they have disclosed material information relating to their securities, see Schapiro Testimony before the Financial Crisis Inquiry Commission Concerning the State of the Financial Crisis 14 January 2010 21-22.
[23] S 80.

the challenges posed by the computerised electronic trading in securities, the South African policy makers should consider enacting additional provisions to prohibit flash orders and dark pools expressly in all the relevant financial markets. In addition, the FSB and the JSE should impose a strict mandatory requirement on the issuers of securities, brokers and other relevant market participants to disclose their trading interests in certain securities promptly and cautiously in order to detect and curb manipulative dark pools and flash orders.

2.3 Hedge Funds Insider Trading and High Yield Securities Investment Fraud

Securities fraud violations such as Ponzi schemes,[24] asset-backed securities market misrepresentations, corporate accounting fraud, prime bank investment fraud involving the fake issuing of certain financial instruments like notes of well-known financial institutions and the pump and dump manipulative schemes were committed increasingly during the global financial crisis.[25] A Ponzi scheme is a type of high yield investment fraud which attracts persons by low risk investment offers and a guarantee of unusually high and fast profit. During the global financial crisis, this scheme was used to deceive investors to unwittingly conclude investment deals which later made them to lose their money. For instance, in the US, Bernard Madoff was arrested on 11 December 2008 and charged with securities fraud after he admitted that he had operated a US$50 billion Ponzi scheme through one of his companies.[26] Hedge funds[27] insider trading also posed enforcement challenges to several regulatory agencies during the global financial crisis. This was caused, in part, by the fact that hedge funds were insufficiently regulated in many jurisdictions. For example, in the US hedge funds were not fully subjected to any disclosure requirements under the federal securities laws while they were totally unregulated in Australia.[28] Consequently, the SEC's Enforcement Division created a Market Abuse Unit which is, *inter alia*, required to combat fraudulent market manipulation schemes and has, together with the Financial Industry Regulatory Authority, the New York Stock Exchange, the Financial Fraud Enforcement Task Force and the Financial Crisis Inquiry Commission begun to investigate hedge funds-related insider trading extensively.[29] Likewise, the UK and Australia stepped up reforms to combat hedge funds insider trading. For example, the UK Treasury published its proposal document entitled *A New Approach to Financial Regulation: Judgement, Focus and Stability* on 26 July 2010 which recommends the establishment of the Financial Policy Committee, the Consumer Protection and Markets Authority and the Prudential Regulation Authority to replace the FSA in a bid to effectively combat fraud and market abuse activities.[30] In Australia, although the Australian Securities and Investments Commission ("the ASIC") is responsible for the general oversight of hedge funds, the debate on whether to regulate hedge funds in line with the International Organisation of Securities Commissions ("the IOSCO")' proposals is still ongoing.[31] In the European Union ("the EU"), the Market Abuse Directive was revised to *inter*

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[24] Named after an early 20th century criminal called Charles Ponzi.
[25] See related remarks by Perkins "Mortgage Fraud, Securities Fraud and the Financial Meltdown: Prosecuting those Responsible" (09-12-2009) <http://www.fbi.gov/news/testimony/mortgage-fraud-securities-fraud-and-the-financial-meltdowm-prosecuting-those-responsible.htm> (accessed 17-06-2013).
[26] He allegedly misrepresented to his investors that they were going to get profits, yet these profits were principal deposits from new investors. He was later sentenced to a 150 years' imprisonment term on 29 June 2009; also see SEC v Stanley Chais (2009) 09 Civ 5681(SDNY) were Stanley Chais was charged for misrepresenting to fund investors that he was managing their investments and, as a result, the SEC brought permanent injunctions, disgorgement of profits and civil penalties against him, for this and other related cases, see Morgan Lewis "2009 Year in Review: SEC and SRO Selected Enforcement Cases and Developments Regarding Broker-Dealers" 2010 56 <http://www.morganlewis.com/lit_SECandYearlyReviewWP_Jan2010.pdf> (accessed 10-06-2013).
[27] Hedge funds are privately owned investment funds from different investors (usually wealth individuals or big financial institutions like banks) which are cooperatively managed by an appointed investment manager. Securities Law Practice Center "Spotlight on Insider Trading in Hedge Funds and M & A" <http://seclawcenter.edu/201106/09/spotlight-on-insider-trading-in-hedge-funds-and-ma/> (accessed 21-06-2013).
[28] D'Aloisio speech entitled The New ASIC: Addressing Today's Challenges and Building for the Longer Term 7 November 2008 17; Shadab "Mercatus on Policy, Hedge Funds and The Financial Crisis" 2009 Mercatus on Policy 1-4; also see generally related comments by Chossudovsky "Global Financial Meltdown" (2008) 4 <http://www.globalresearch.ca/index.php?context=10268> (accessed 17-07-2013).
[29] See SEC v Arthur J Cutillo and others (2009) 09 Civ 9208 (SDNY) where Wall Street traders and hedge funders gained over US20 million through insider trading by trading ahead of acquisition announcements; SEC v Galleon Management and others (2009) 09 Civ 8811 where the perpetrators gained over US$33 million in profits and losses avoided through insider trading ahead of corporate announcements and to date 21 individuals have been charged with hedge funds insider trading and seven of them pleaded guilty, also see generally Bray "The Galleon Case: Kumar Says He Was Paid for Tips" 2010 The Wall Street Journal C3. In this regard, see further Morgan Lewis 2010 2-9; 19-21 <http://www.morganlewis.com/lit_SECandYearlyReviewWP_Jan2010.pdf> (accessed 10-06-2013).
[30] These new regulatory bodies are expected to come into force in 2012. Generally see related analysis by Dyer "Overhauling the Regulation of Global Financial Services" (2010) <http://www.dorsey.com/dyer.caroline.pdf> (accessed 07-07-2013).
[31] In relation to this, insider trading and market manipulation cases for example the Tricom & Allco & Rubicom cases were successfully enforced in Australia during the global financial crisis, see the ASIC's Annual Report 2007-2008; D'Aloisio speech entitled The New ASIC: Addressing Today's Challenges and Building for the Longer Term 7 November 2008 17.

alia extend harsher penalties to the persons who engage in market manipulation and insider trading (including hedge funds insider trading) in over the counter derivatives markets.[32]

2.3.1 Evaluation of the South African Anti-Market Abuse Enforcement Framework

The Financial Markets Act's market abuse provisions do not expressly prohibit hedge funds insider trading and high yield investment fraud.[33] Nevertheless, the Financial Markets Act provides that a central securities depository may hold securities of the same kind collectively in a separate central account,[34] similar to hedge funds which are also separately managed.[35] However, apart from mandating the central securities depository to disclose certain information from its participants to the registrar of securities services and to conduct its services in a prudent manner,[36] the Financial Markets Act does not expressly empower the FSB to combat hedge funds insider trading and commodities derivatives insider trading. The Companies Act 2008 does not expressly prohibit hedge funds insider trading and high yield securities investment fraud but it does, however, prohibit companies from engaging in reckless trading and executing their business under insolvent circumstances and/or with gross negligence in order to defraud investors.[37] No clarity is given as regards the types of companies that are specifically targeted by this anti-fraud provision. Accordingly, it is hoped that additional provisions will be enacted in accordance with other applicable reforms and proposals that were introduced elsewhere[38] to expressly prohibit hedge funds market abuse activities and other securities violations, especially in over the counter markets.

2.4 High Frequency Trading

High frequency trading is a manipulative practice that involves persons like brokers, issuers and financial analysts who act in a proprietary capacity to employ sophisticated computerised algorithmic decision-making systems in order to obtain advantage from some minute discrepancies in the financial markets stock prices and then quickly trade in such stocks in large quantities to gain profit.[39] It is stated that high frequency trading by investment banks and hedge funds contributed about 60% to 70% of all stock trades in the US's financial markets during the global financial crisis and in relation to this, high frequency trading profits between US$8 billion and US$21 billion were recorded in 2008. The Commodity Futures Trading Commission and the SEC formed a committee which recommended the adoption of minimum regulatory requirements such as restrictions on direct access and co-location, the imposition of penalties for rapid order cancellation and basic quoting requirements for high frequency trading related practices.[40] However, it is reported that the enforcement of high frequency trading regulations remains challenging for many regulators because the offenders usually have highly sophisticated and automated algorithmic trading mechanisms that are capable of offering high speed stock order responses and to trade on such stock price movements after a certain threshold is reached. It is submitted that lax or inconsistent regulation of high frequency trading can unfairly allow large financial institutions to engage in market abuse activities and related financial markets systemic risks to the detriment of small investors. The financial markets flash crash of 06 May 2010 is a case in point. In response to this flash crash, the SEC proposed rules to combat risks associated with high frequency trading related practices like erroneous flash orders and naked accesses.[41] Nonetheless, as is the case in the EU and Australia,[42] the SEC has not yet adopted a specific rule to curb high frequency trading related market abuse activities.

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[32] *Paulo 2011 Fondation Robert Schuman 6 & 10 <http://www.robert-schuman.eu/frs-fichecrisefi-qe200-en.pdf> (accessed 04-07-2013).*
[33] *See ss 78; 80; 81 & 82.*
[34] *S 30(2)(l).*
[35] *See paragraph 2.3 above.*
[36] *S 30.*
[37] *S 22(1).*
[38] *See paragraph 2.3 above.*
[39] *Bhupathi "Technology's Latest Market Manipulator? High Frequency Trading: The Strategies, Tools, Risks and Responses" 2010 North Carolina Journal of Law and Technology 377 386; Wagner & Bhala "Is High Frequency Trading Ethical?" <http://sevenpillarsinstitute.org/case-studies-high-frequency-trading> (accessed 04-07-2011); also see analysis by Anonymous "High Frequency Trading Regulation" (17-05-2011) <http://www.marketsreformwiki.com/mktreformwiki/index.php/High-Frequency-Trading-Regulation> (accessed 04-07-2011).*
[40] *See Anonymous "The Impact of High Frequency Trading: Manipulation, Distortion or a Better-Functioning Market?" <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2345> (accessed 17-06-2011).*
[41] *Also see SEC Rule 15c3-5 which requires a broker-dealer that has market accesses to establish, document and maintain risk management controls and supervisory measures designed to manage the financial, regulatory and other legal or operational risks related to such market access; also see Bhupathi 2010 North Carolina Journal of Law and Technology 391-393; 397 & 400.*
[42] *See the comments and analysis by Anonymous "High Frequency Trading Regulation" (17-05-2011) <http://www.marketsreformwiki.com/mktreformwiki/index.php/High-Frequency-Trading-Regulation> (accessed 04-07-2011).*

2.4.1 Evaluation of the South African Anti-Market Abuse Enforcement Framework

Notwithstanding their fairly wide market abuse prohibition, the Financial Markets Act[43] does not specifically discourage high frequency trading, Internet-based market manipulation, program trading and other related technologically perpetrated market abuse activities. Likewise, the Companies Act 2008 does not specifically discourage the high frequency trading and other related practices. Although the Financial Markets Act[44] provide inexhaustible instances where some practices may be deemed to be trade-based market manipulation, it is submitted that additional provisions should be enacted to expressly prohibit high frequency trading, Internet-based market manipulation and program trading to enable the FSB to combat technologically related market abuse activities in the South African financial markets. The JSE has reportedly boosted its information technology department to enhance its efficiency especially with regard to its clearing systems, Yield-X interest transactions and Equities derivatives by requiring its members to use the Broker Deal Accounting system[45] to enable it to detect market abuse practices involving certain beneficial ownership trades. Nonetheless, it is suggested that the JSE and the FSB should consider employing practically applicable proposals from other jurisdictions such as the back testing process, real-time risk monitoring and market surveillance measures to combat high frequency trading related market abuse activities.

2.5 Credit Default Swaps

Credit default swaps are "bilateral contracts designed for credit hedging or speculative investment and issues relating counterparty risk, operational risk and market transparency".[46] During the global financial crisis most of the credit default swaps derivatives were traded on the over the counter markets by bond holders to transfer debt default risk from the buyer to the seller.[47] It is further argued that the complexity and opaqueness of credit default swaps exacerbated systemic risks involving market manipulation and insider trading, particularly in the over the counter markets during the global financial crisis.[48] Both the Group of Thirty and the IOSCO submit that credit default swaps were largely used for speculative purposes giving rise to market abuse activities, increased counterparty risk, operational risk and lack of transparency in the over the counter credit default swaps derivatives markets.[49] In response to these challenges the IOSCO proposed the establishment of an adequate central counterparties' regulatory framework to: (a) promote cooperation and relevant information sharing among the regulators; and (b) mandatorily require financial institutions and market participants to work on standardised credit default swaps to facilitate central counterparties clearing.[50] In the same light, on 08 June 2010 the European Commission ("the EC") president, Jose Manuel Barosso, submitted that member states should consider prohibiting naked short selling and naked credit default swaps in order to empower their regulators to prevent market abuse activities.[51] The EC further proposed that regulators should require all market participants to disclose relevant information in order to increase transparency and to ensure that sellers of credit default swaps are in

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[43] See ss 78; 80; 81 & 82.
[44] S 80(3).
[45] This system keeps the securities records and books of brokerage companies; also see further Loubser "CEO's Statement" <http://www.jse.co.za/ceo/statement/public.JSE.pdf> (accessed 10-10-2013).
[46] IOSCO Task Force on Unregulated Financial Markets and Products Technical Committee Final Report 2009 8-5 <http://www.iosco.org/library/pbdocs/pdf/IOSCOPD301.pdf > (accessed 07-07-2013).
[47] This created counterparty risk especially with regard to defaults involving mortgage related securities asset-backed securities which affected a number of financial institutions such as AIG, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bear Stearns, Lehman Brothers and General Motors. See Mazumder & Ahmed "Greed, Financial Innovation or Laxity of Regulation? A Close Look into the 2007-2009 Financial Crisis and Stock Market Volatility" 2010 Studies in Economics & Finance 110 116-118; Shadab "Guilty by Association? Regulating Credit Default Swaps" 2010 Entrepreneurial Business Law Journal 407 441-452.
[48] See the IOSCO Task Force on Unregulated Financial Markets and Products Technical Committee Final Report 2009 13-14 <http://www.iosco.org/library/pbdocs/pdf/IOSCOPD301.pdf> (accessed 07-07-2013); the G20 Working Group 1 on Enhancing Sound Regulation and Strengthening Transparency 25 March 2009; Whalen What is to Be Done With Credit Default Swaps paper presented to Institutional Risk Analytics, at the American Enterprise Institute (23-02-2009) <http://www.rcwhalen.com/pdf/cds_aei.pdf> (accessed 07-07-2013) and also see the related remarks and discussion by the G20 London Summit Communiqué which can be accessed at <http://www.g20.org/Documents/g20_communique_020409.pdf> (accessed 17-06-2013); the Bank for International Settlements Credit Risk Transfer: Developments From 2005 to 2007 The Joint Forum July 2008 21.
[49] Group of Thirty Financial Reform: A Framework for Financial Stability 15 January 2009 53; IOSCO Task Force on Unregulated Financial Markets and Products Technical Committee Final Report 2009 29 <http://www.iosco.org/library/pbdocs/pdf/IOSCOPD301.pdf> (accessed 07-07-2013); According to the International Swaps and Derivatives Association, the total mark to market counterparty risk exposure involving over the counter credit default swaps derivatives was approximately US$600 trillion; also see the Bank for International Settlements Quarterly Review Statistical Annex June 2009 A10.
[50] IOSCO Task Force on Unregulated Financial Markets and Products Technical Committee Final Report 2009 32-38 <http://www.iosco.org/library/pbdocs/pdf/IOSCOPD301.pdf> (accessed 07-07-2013).
[51] Buiter Lessons From the Global Financial Crisis 8-11; Vander Stichele "EU Financial Reform: Some Small Steps, but no Fundamental Changes in Sight" (2010) 25-31 <http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletters> (accessed 08-07-2013).

actual possession of the asset to be sold at the time when it will be due to be delivered.[52] In Australia, the ASIC and other regulators formed a working group to study international developments in order to review the Australian credit default swaps market in line with such developments to promote transparency and to curb counterparty risk and market abuse activity.[53] In the same light, in July 2009 the US Treasury proposed: (a) the implementation of data repositories for uncleared transactions to enhance transparency by mandating central counterparties to report or disclose relevant information to a regulated trade repository, regulators and the public; (b) the establishment of a central counterparty to clear standardised over the counter credit default swaps derivatives.[54] Credit default swaps are not regulated under federal commodities laws but are nonetheless, partially regulated in accordance with the SEC's restricted jurisdiction over security-based swaps and federal bank regulators.[55] Accordingly, the SEC adopted exemptions requirements to allow local credit default swaps users to employ central counterparties and exchange traded credit default swaps.[56] Nevertheless, these requirements are merely contingent upon the central counterparties and/or market participants to choose whether or not to comply with them.

2.5.1 Evaluation of the South African Anti-Market Abuse Enforcement Framework

The Financial Markets Act's market abuse provisions apply only to trades conducted on a regulated market and they do not directly or indirectly prohibit illicit or naked credit default swaps derivatives transactions in the over the counter markets.[57] These provisions, unlike the position in Australia and the US,[58] do not specifically empower the FSB and the JSE to develop their own measures to clear standardised credit default swaps and to cautiously allow exchange traded credit default swaps in the regulated markets to prevent market abuse related counterparty risk. Likewise, the Companies Act 2008 does not prohibit naked credit default swaps.[59] On the contrary, the Financial Markets Act provide some general provisions which require an exchange,[60] central securities depository (including an external central securities depository),[61] a trade repository,[62] participant[63] and clearing house[64] to employ security and back-up procedures and necessary measures to ensure that market participants will use an independent clearing house[65] as a central counterparty to clear unlisted securities as suggested by the Group of Twenty ("the G20") and the IOSCO. Nonetheless, it is not clear whether the unlisted securities that can be cleared by an independent clearing house will also include credit default swaps derivatives. On the other hand, the JSE now regulates both the Equities and commodity derivatives markets.[66] However, in contrast to the position in other jurisdictions,[67] the JSE uses a non-standardised derivative instruments system called Can-Do Derivatives which is largely dependent on the terms of investors but traded and/or valued by the JSE and cleared by its own clearing house called Safcom (Proprietary) Limited.[68] It is suggested that the JSE should combat naked credit default swaps by allowing over the counter credit default swaps derivatives to be standardised and cleared by an independent central counterparty.

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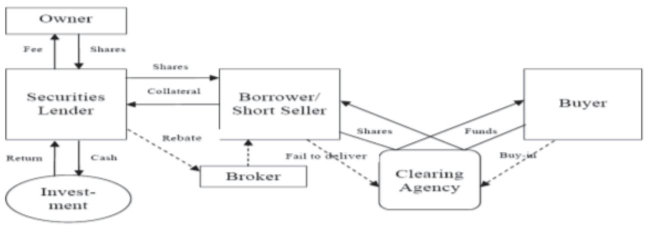
[52] Paulo 2011 Fondation Robert Schuman 14-16 <http://www.robert-schuman.eu/frs-fichecrisefi-qe200-en.pdf> (accessed 04-07-2013); Verhelst "Addressing the Financial Crisis: The EU's Incomplete Regulatory Response" 2010 Egmont Institute for International Relations Paper 39 27-29 <http://www.egmontinstitute.be.ep39.pdf> (accessed 08-07-2013).
[53] D'Aloisio speech entitled The New ASIC: Addressing Today's Challenges and Building for the Longer Term 7 November 2008 16.
[54] The IOSCO Task Force on Unregulated Financial Markets and Products Technical Committee Final Report 2009 35-36 <http://www.iosco.org/library/pbdocs/pdf/IOSCOPD301.pdf> (accessed 07-07-2013); Anonymous Letter From Participants to the Federal Reserve Bank of New York and Other National Regulators (02-06-2009) <http://www.ny.frb.org/newsevents/news /markets/2009/ma090602.html> (accessed 07-06-2011); Shadab 2010 Entrepreneurial Business Law Journal 410.
[55] Only security-based swaps (a type of credit default swaps) are subject to anti-fraud and market manipulation contained in s 17(a) of the Securities Act of 1933 15 USC 77q(a) (2006) as amended by PL-111-229 (approved 11-08-2010) & Rule 10b-5; s 9(a)(2) to (5) & s 10b of the Securities Exchange Act of 1934 15 USC 78i(a)(2)-(5) (2006) as amended by PL-111-257 (approved 05-10-2010); In relation to this, contract law private rights of action can be imposed on over the counter (OTC) market trades (including credit default swaps), see Shadab 2010 Entrepreneurial Business Law Journal 419-421.
[56] Shadab 2010 Entrepreneurial Business Law Journal 452.
[57] Ss 78; 80; 81 & 82.
[58] See paragraph 2.5 above.
[59] This is the same position under the National Credit Act 34 of 2005.
[60] Ss 8 &10.
[61] S 28.
[62] Ss 54 to 58.
[63] S 32(h) & (i).
[64] S 48.
[65] S 50(3) read with s 53.
[66] All commodities including metals and oil are now traded on the JSE and this was made through cooperation with related bodies like the Chicago Board of Trade and the CME Group (world's largest derivatives exchange).
[67] See paragraph 2.5 above.
[68] Loubser "CEO's Statement" <http://www.jse.co.za/ceo/statement/public.JSE.pdf> (accessed 10-10-2013).

2.6 Short Selling

Short selling is a practice which involves selling securities or assets such as derivatives by the seller without owning them at the time of the transactions, with the intention of buying them back at a later stage but at a much lower price.[69] Where the value of the asset or security in question depreciates during the period between the time of the sale and its actual delivery, the seller will illicitly gain profit.[70] This is sometimes referred to as "covered" short selling. An overview of how short selling transactions are executed is reflected in the figure 1 that follows, which shows that the short seller usually borrows the securities to be sold and later buys them back from the relevant persons or financial markets in order to return such securities to the initial lender.

The short seller will then make a profit when the price of securities in question falls and loses when the price of securities rises to new margins than were previously anticipated.[71] The parties involved in short selling may include an initial lender (original owner of the securities), a broker, a short seller (borrower of the securities), a buyer, securities lender or an exchange and a clearing agency which oversees the clearing of all the securities transactions as indicated in figure 1 below:

Figure 1: Overview of the Equity Loan and "Covered" Short Selling Structure.



Adapted from Gruenewald, Wagner & Weber.[72]

In contrast to covered short selling as illustrated above, "naked" short selling occurs when a seller agrees to short sell a security within a stipulated period without taking prior measures to repurchase it at a later stage.[73] Comparatively speaking, it is submitted that naked short selling is riskier than covered short selling because the seller is not assured of getting the security sold back at a later period.[74] There has not been any consensus regarding the regulation of short selling. Some commentators argue that short selling is detrimental to financial markets stability[75] while others maintain that prohibiting short selling negatively affects the liquidity and efficiency of the financial markets.[76] Be that as it may, this

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[69] *Paulo 2011 Fondation Robert Schuman 15 <http://www.robert-schuman.eu/frs-fichecrisefi-qe200-en.pdf> (accessed 04-07-2013); see further discussion by Gruenewald, Wagner & Weber "Short Selling Regulation After the Financial Crisis-First Principles Revisited" 2009 Swiss Finance Institute Research Paper Series 09-28 4 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013); see similar remarks by Verhelst 2010 28 <http://www.egmontinstitute.be.ep39.pdf> (accessed 08-07-2013).*

[70] *Paulo 2011 Fondation Robert Schuman 15 <http://www.robert-schuman.eu/frs-fichecrisefi-qe200-en.pdf> (accessed 04-07-2013).*

[71] *See Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 5-6 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013); also see Gatev, Goetzmann & Rouwenhorst "Pairs Trading: Performance of a Relative-Value Arbitrage Rule" 2006 Review of Financial Studies 797 799-827.*

[72] *See Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 5 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013) for further analysis.*

[73] *Verhelst 2010 28 <http://www.egmontinstitute.be.ep39.pdf> (accessed 08-07-2013).*

[74] *Verhelst 2010 28 <http://www.egmontinstitute.be.ep39.pdf> (accessed 08-07-2013); also see similar sentiments in Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 5-10 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013) for further analysis.*

[75] *Allen & Gale "Arbitrage, Short Sales and Financial Innovation" 1991 Econometrica 1041 1041-1068; also see Shkilko, Van Ness & Van Ness "Price-Destabilizing Short Selling" 2009 SSRN Working Paper <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=971210> (accessed 05-09-2013).*

[76] *Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 13-17 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013); Bris; Goetzmann & Zhu "Efficiency and the Bear: Short Sales and Market Around the World" 2007 Journal of Finance 1029 1029-1079; Boehmer & Wu "Short Selling and the Informational Efficiency of Prices" 2008 SSRN Working Paper <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972620> (accessed 06-09-2013), who argues that the SEC's temporary ban on short selling resulted in share price increase and high liquidity in about 1000 financial stocks that were covered by this ban; Beber & Pagano "Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis" 2009 CSEF Working Paper 241 who maintains that the temporary short selling bans adopted during the global financial crisis reduced the liquidity of the financial markets in many countries as empirically proven by a survey they conducted from 01 January 2008 to 23 June 2009 using about 17 040 stocks from 30 countries & also see Ofek & Richardson "DotCom Mania: The Rise and Fall of Internet Stock Prices" 2003 Journal of Finance 1113 1115-1137.*

research submits that naked short selling should be adequately prohibited to prevent market abuse related systemic risks.

In the US short selling has been regulated as early as the 1938 through the price test prohibition (uptick rule).[77] Before the global financial markets crisis, broker-dealers were restricted from short selling through the Regulation SHO.[78] In September 2008 the SEC enforced a temporary short selling ban on options markets to combat naked short selling and other market abuse activities.[79] Moreover, the Regulation SHO was amended to permanently extend the short selling restrictions, especially with regard to equity securities to discourage naked short selling and other market abuse activities.[80] The EC also proposed reforms to: (a) increase transparency in short selling practices; (b) harmonise rules regarding whether to ban short selling permanently; and (c) discourage short selling across the EU member states.[81]

The EC further submitted that short sellers must now be in actual possession of the security or asset which they intend to sell and that the European Securities and Markets Authority may, in exceptional cases, impose a restriction or absolutely prohibit naked short selling to curb speculative market manipulation.[82] The author concurs with Culp and Heaton,[83] Goldstein and Guembel[84] and Shkilko, Van Ness and Van Ness[85] that naked short selling may increase market abuse activity in the financial markets[86] and further submits that short selling must be regulated by independent bodies to maintain financial markets efficiency and stability.

2.6.1 Evaluation of the South African Anti-Market Abuse Enforcement Framework

The current South African anti-market abuse enforcement framework primarily deals only with insider trading and market manipulation.[87] Accordingly, there are no market abuse provisions which explicitly prohibit short selling under the Financial Markets Act.[88] Therefore, in contrast to the position in the UK,[89] the US and Europe,[90] the decision to ban short selling has not yet been statutorily considered in South Africa. It is submitted that this gap could give some devious persons an easy conduit to commit market abuse offences without incurring liability. After the global financial crisis, the JSE, in addition to its Broker Deal Accounting system and other surveillance systems, introduced some restrictions on short selling in September 2008.[91] These restrictions were targeted at restoring investor confidence in the JSE Equity derivatives and securities by combating possible short selling related market abuse activities.[92] However, it remains uncertain whether these short selling restrictions are enforced by the JSE itself, or by the courts and the FSB. Given this obscurity, it is hoped that the Financial Markets Act will be fastidiously amended, giving regard to relevant applicable developments in other jurisdictions[93] to expressly prohibit naked short selling.

3. Concluding Remarks

As discussed above, it is evident that various challenges are still embedded in the South African anti-market abuse enforcement framework, especially, in the wake of some market abuse practices that manifested during the global

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[77] *Formerly Rule 10a-1 of the Securities Exchange Act of 193415 USC 78i(a)(2)-(5) (2006) as amended by PL-111-257.*
[78] *Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 31-33 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013).*
[79] *See Rule 10b-21 (a naked short selling anti-fraud Rule) which is also a final Rule under the Securities Exchange Act of 1934 15 USC 78i(a)(2)-(5) (2006) as amended by PL-111-257; also see Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 31-33 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013).*
[80] *Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 34-41 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013).*
[81] *Verhelst 2010 28-29 <http://www.egmontinstitute.be.ep39.pdf> (accessed 08-07-2013).*
[82] *Paulo 2011 Fondation Robert Schuman 15 <http://www.robert-schuman.eu/frs-fichecrisefi-qe200-en.pdf> (accessed 04-07-2013).*
[83] *Culp & Heaton "The Economics of Naked Short Selling" 2008 Regulation 46 46-51.*
[84] *Also see Goldstein & Guembel "Manipulation and the Allocational Role of Prices" 2008 Review of Economic Studies 133 135-164.*
[85] *Shkilko, Van Ness & Van Ness 2009 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=971210> (accessed 05-09-2013).*
[86] *See Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 21-23 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013).*
[87] *Ss 78; 80; 81 & 82.*
[88] *See ss 78; 80; 81 & 82.*
[89] *See Gruenewald, Wagner & Weber 2009 Swiss Finance Institute Research Paper Series 09-28 13-14; 21 & 41-44 <http://ssrn.com/abstract=1439652> (accessed 08-07-2013).*
[90] *See paragraph 2.6 above.*
[91] *Loubser "CEO's Statement" <http://www.jse.co.za/ceo/statement/public.JSE.pdf> (accessed 10-10-2013).*
[92] *Loubser "CEO's Statement" <http://www.jse.co.za/ceo/statement/public.JSE.pdf> (accessed 10-10-2013).*
[93] *See paragraph 2.6 above.*

financial crisis and the combating of such practices in the South African financial markets.[94] Consequently, it is suggested that the Financial Markets Act should be amended in order to enact provisions that directly and expressly apply to possible quote stuffing and front running that might occur in the over the counter commodity and commodity derivatives transactions.[95] It is further submitted that the Financial Markets Act should be amended to provide a mandatory requirement on the part of the financial analysts or advisors, brokers and other market participants to openly hold onto their orders for specific minimum periods in order not to prejudice investors through quote stuffing or front running.[96]

Moreover, it is submitted that additional provisions should be enacted to expressly prohibit flash orders and dark pools in all the relevant financial markets.[97] In addition, it is submitted that the FSB and the JSE should strictly impose a mandatory requirement on the issuers of securities, brokers and other relevant market participants to disclose their trading interests in certain securities promptly and cautiously in order to detect and curb manipulative dark pools and flash orders.[98]

It is further submitted that additional provisions should be enacted in accordance with other applicable reforms and proposals that were introduced elsewhere to expressly prohibit hedge funds market abuse activities and other securities violations, especially in the South African over the counter markets.[99]

Moreover, it is recommended that the JSE and the FSB should consider employing practically applicable proposals from other jurisdictions such as the back testing process, real-time risk monitoring and market surveillance measures to combat high frequency trading-related market abuse activities.[100]

It is also submitted that the Financial Markets Act should be amended in order to provide a specific prohibition on naked credit default swaps and appropriate penalties against the offenders.[101] Furthermore, it is suggested that the Financial Markets Act should be fastidiously amended, giving regard to relevant applicable developments in other jurisdictions[102] to prohibit naked short selling expressly.[103]

In conclusion, it is hoped that the market abuse challenges as stated in this article will be appropriately resolved for the purposes of combating market abuse activities in South Africa. In line with this, it is further hoped that the recommendations as enumerated in this article will be employed by the relevant stakeholders in the future to enhance the combating of such activities in the South African financial markets.

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[94] See the sub-paragraphs under paragraph 2 above; also see Cassim "An Analysis of Market Manipulation under the Securities Services Act 36 of 2004 (part 1)" 2008 SA Merc LJ 33 33-36.
[95] See paragraph 2.1.1 above.
[96] See paragraph 2.1.1 above.
[97] See paragraph 2.2.1 above.
[98] See paragraph 2.2.1 above.
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