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CONFLUENCE

JOURNAL

**OF JURISPRUDENCE AND
INTERNATIONAL LAW**



A publication of
**THE DEPARTMENT OF
JURISPRUDENCE AND INTERNATIONAL LAW,
FACULTY OF LAW, KOGI STATE UNIVERSITY, ANYIGBA.**

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1. INTRODUCTION

Insider Trading is the trading of a company's securities by its officers, employees, members, or other interested parties on the basis of confidential information solely obtained by reason of their relationship with the company. Modern day legal/financial thinking considers such practice to be unfair, fraudulent, an abuse of the securities market, well as being a breach of the fiduciary principles of transparency and disclosure, which are the elements of good corporate management. Although securities' laws vary widely from country to country, the vast majority of jurisdictions, including Nigeria, outlaw the practice, at least in principle.

The advent of the internet age had (as in other forms of human activities) ushered in significant changes in the manner securities are being traded. It is indisputable that trading of securities on the internet is a welcome development. But, many fraudulent practices associated with the securities market including insider trading had resurfaced in the online security market.

This paper examines the practice of insider trading, the rationale behind its prohibition, and applicable Nigerian law(s). It reviews the changes introduced by the internet in securities trading, the emergence of insider trading on the on-line market, the current global efforts to curb such practices, and recommendations on what could still be done, particularly in Nigeria.

2. THE PRACTICE OF INSIDER TRADING

Generally, insider dealings in company securities refers to transactions involving company securities by persons who are said to be insiders, in that by virtue of their relationship with the company, they possess some 'inside' information, not available to the public, which is material to the transaction concerned.¹

Section 264 of Investment and Securities Act² states that insider trading occurs "where a person or a group of persons who are in the possession of some confidential and price sensitive information not generally available to the public, utilizes such information to buy and sell securities for the benefit of himself, itself or any other person".

From the above statutory definition, there are 3 major elements in an insider dealing:

- (a) The information is confidential corporate information
- (b) The information is price sensitive
- (c) The information is being used with a view to making personal profits.

From this analysis, and as will be seen elsewhere in this paper, it is confidential and price sensitive corporate information that is being protected from private profit making rackets, unconnected to the good of the company.

To properly appreciate the scope of insider trading and why it is considered illicit; it is essential to profile the typical insider trader, how he operates in the security market, and the consequences of his seemingly harmless act.

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¹ Abugu J.E., *Company Securities: Law and Practice*. (Lagos: Unilag Press, 2005) p. 235

² Cap 115, Laws of the Federation of Nigeria, 2004.

The typical insider trader falls within 3 broad categories:³

- (a) The classic insider who is associated with a company and actively pursues inside price sensitive information in order to trade on it. This category also includes the constructive insider i.e. the company's outside auditors, bankers, solicitors etc, who also acquire the fiduciary obligations of the classic insider.
- (b) The opportunist who does not actively pursue inside information, but merely stumbles on a single opportunity to make profit. An example is the head of a thriving family business, who was suddenly presented with an unsolicited, confidential take-over offer by a larger company. This fellow may have never contemplated insider trading, but is unable to resist the temptation of a quick profit on this occasion.
- (c) The member of a highly sophisticated group, each of whom manages a large trust or investment firm. When one of the group receives inside information, he notifies other members of the group. The members will then trade among themselves, profiting both their trusts and their personal portfolio.

3. THE SECURITIES MARKET

The securities market, where the insider trader operates, is a specialized trading place where financial instruments like stocks, bonds, treasury bills etc are bought and sold. It is very important to note that, unlike in commodities market where purchases are premised on physical inspection, assessment, and comparison of goods, the investment decision to buy or sell an instrument being traded in the securities market is solely based on information about the issuer and the instrument itself⁴. To be useful to investors, such information must be correct, complete, and up to date. An investment decision that is premised upon wrong or misleading information would, inevitably, result in loss of money to the investor. It stands to reason, therefore, that it is the fellow who has (or claims to have) accurate information about a particular company that will be in vantage position to profitably trade in that company's securities. Thus, securities traders/investors strive to get the inside information about a company before making a decision to trade in that company's securities. More often than not, they scheme to cultivate the directors, officers, employees, or in some cases, influential members of the company who can give them such 'inside' information. Realizing the financial implications of corporate information which they held, these insiders soon began a personal practice of trading in the company's securities, with a view to making personal gains, and in breach of their fiduciary obligation not to make personal profits from their use of corporate assets.⁵

The security market, itself, is a highly regulated environment. The securities market is viewed by most Governments as an effective agency for channeling funds into productive enterprises, which would drive economic development and help reduce unemployment. Thus, any act which tends to undermine the integrity of the market (otherwise called market abuses) are usually frowned at, and outlawed for the simple reason that such individual practices are capable of eroding the larger investing public's confidence in the market, which is critical to the

³ This writer gratefully adopts, with slight variations, the models suggested by Dr. J.E. Abugu, Op. cit., n1, p. 237.

⁴ Ndanusa Suleiman, *The New Investments and Securities Act*. A paper presented at the Nigerian Law School, Bwari, Abuja, in October 2001.

⁵ See the case of *United State v. O' Hagan*, [1997] 521 U.S. 642, 655 where the U.S. Supreme Court specifically recognized that a corporation's information is its property: "A company's confidential information... qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information in violation of a fiduciary duty... constitutes fraud akin to embezzlement-the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another."

continuous flow of funds for overall national development⁶. Such acts include concealment of material information, insider trading, market manipulation, artificial price fixing etc.

From the above, one could premise the legal prohibition on insider trading on a combination of moral, fiduciary, as well as on public policy grounds.

Although, by and large, there is a prevailing consensus that insider trading is illicit, there are pockets of dissention from notable scholars. For instance, Professor Milton Friedman, laureate of the Nobel Prize in Economics, has argued with considerable force that:

You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that fact... the insider trader should not be required to make his trade known to the public, because the buying or selling pressure itself is information for the market.⁷

The legal regime against insider trading practices

Although the common law had long imposed a fiduciary duty not to make secret profits in the company on directors and other principal officers of the company, early attempts at applying this common law rule to insider trading regulation, as characterized by the position of the court in the case of *Percival v. Wright*,⁸ merely limits the fiduciary duty of disclosure of the director to the company as principal, and does not extend it to the shareholders of the company except where circumstances show that in a particular transaction, the directors acted as agents for the shareholders.

Over the years, it was seen that this position was deficient in 2 major ways:

- (a) It covers only directors, officers and persons who can be classified as fiduciaries of the company. Other classes of people who by their connection have access to inside information were excluded.
- (b) Even within the area covered by the above rule, the fiduciary obligation was limited to the company itself. It was not extended to the members of the company and potential shareholders who may also suffer from the activity of the insider dealers⁹.

However, by the late 20th century, the strategic importance of the securities market to national economies, and its regulation had come into sharp focus, leading to a global wave of securities market legislations which, amongst other provisions, remedied the shortcomings of the *Percival v Wright* rule, and by which market abuses such as insider trading have come under specific regulation.

The principal insider trading legislation in Nigeria is contained in Section 88-95 of the investment and Securities Act, relevant portions of which will be briefly discussed hereunder.

⁶ The nexus between maintaining good corporate practices, ensuring a healthy and fair securities market and economic prosperity will be better appreciated with the U.S. experience. The U.S. stock market crash of 1929, which led to the Great Economic Depression of the 1930's, was widely attributed to the activities of corporate insiders. The U.S. Senate hearings which ensured unearthed flagrant abuses of inside information by several people in fiduciary positions. See U.S. Senate Committee Report No. 1455. 73rd Congress. 2nd Session. 55 (1934)

⁷ Milton Friedman, 'Insider Trading' in Larry, Harris (ed), *Trading and Exchanges. Trading & Exchanges.* (Oxford: Market. (Free Press, 1966)

⁸ (1902) 2 Ch. 421 See also *Briess v. Wooley* (1954) A.C. 333

⁹ See Gower's *Principles of Modern Company Law.* (6th Ed: 1997) pp. 444-452.

The typical on-line fraudster often poses as an insider of a company, and makes use of internet chat-rooms and bulletin to spread 'inside' information.

A Typical Investor Bulletin Board Scam

"Is anyone out there following Company x?"

Reads the first message on an online bulletin board. Responses follow:

"I heard that Company x is about to make a major announcement. E-mail me or call this toll-free number to get an insider information package."

"I spoke to Company x's CEO who confirmed details of next month's big news. I've bought 10,000 shares. Look for share price to double in next month! Get it now!"

"Big news is just around the corner. We hear from a friend who has visited company x that it is going to be even bigger than we thought. There's still time to get in."

"Short-sellers are in the market! Keep the faith... This will bounce back. The smart money will use the price as an opportunity to buy more and dollar average."

The original message in this hypothetical bulletin board is usually posted by an unscrupulous company, market-making brokerage or large shareholder. Subsequent messages could be left by the same person using an alias or by accomplices posing as disinterested outsiders. The goal would be to interest unwary investors, who then drive up the stock price through a buying surge. The schemers stand to make substantial profits when they sell their cheap shares. After the price collapses, talk of the company ceases and the faceless schemers move on, hyping a new stock. This is old fashioned market manipulation dressed up in a new skin!

5. INSIDER TRADING ON THE INTERNET

One of the earliest known cases of insider dealings over the internet was the American case of *SEC v. John Freeman & 18 Ors*¹⁴ where the securities and Exchange Commission cracked an internet based insider trading ring of 19 people, some of whom had never met, but who from 1997 through January 2000, engaged in a widespread scheme that produced over \$8 billion in illegal profits from trading in the securities of 23 public companies. The source of the inside information in this case was John Freeman, who was a part-time word processor assigned by the temporary agency where he worked to two Wall Street investment banking firms, Goldman Sachs & Co. Inc., and Credit Suisse First Boston Corporation.

The scheme first began in mid-1997 when John Freeman met the 2nd and 3rd defendant in an internet chat room. The three then formed a plan in which Freeman would pass on any stock tips he discovered during the course of his work at Goldman Sachs and, later at Credit Suisse First Boston. John Freeman learned about some deals as part of his normal duties, which involved working on some confidential documents. Other information came from helping co-workers on their assignments, looking through the brokerages' internal computer systems, and by looking through documents he found at printers and copiers. Based on information provided by Freeman, each of the defendants traded in the common stock and/or options of some or all of 23 different public companies, each of which was involved in a significant transaction that involved the merger or sale of the company. The ring soon grew to involve many tippees, which eventually led to their discovery.

Freeman covered up payment for his "services" ingeniously. Some of those that he tipped paid in cash, (in some instances, cash was enclosed in unsigned birthday cards sent to Freeman in envelopes bearing no return addresses), whilst in some instances, checks were sent to third parties who cashed them and funneled the money to Freeman. One beneficiary disguised his payment as

¹⁴ See U.S. SEC Litigation Release No. 16469/ March 14, 2000 available at www.sec.gov/news/press.

a "loan" to a friend of Freeman, who then repaid the loan to Freeman. Another fellow paid Freeman in cases of wine. All were held liable of insider trading.

Another interesting instance of an internet-enabled international insider trading ring is the case of *SEC v. Sonja Anticevi & 16 Ors*¹⁵ (the Reebok trading case) in which two individuals, one current and one former employee of Goldman, Sachs & Co., engaged in a complex and wide-ranging scheme in which they illegally obtained inside information from various sources and then forwarded the tips to multiple co-conspirators who traded on them throughout the United States and Europe in transactions that netted at least \$6.8 million in illicit gains.

SEC's spotlight was beamed upon this setup in August 2005, when a retired Croatian seamstress made a series of sophisticated options trades that essentially amounted to an unlikely bet that the stock of Reebok International, Ltd. would rise quickly. In fact, just a day after her last trade, Reebok announced that it had agreed to be acquired by Adidas-Salomon, AG, netting the seamstress a profit of over \$2 million. Because of this extraordinary and fortuitous profit by an apparently inexperienced options trader, SEC filed an emergency action freezing the securities account in which these trades were made. Detailed investigations revealed that the seamstress was in fact trading on instructions from her nephew, former Goldman, Sachs broker David Pajcin and that Pajcin's co-principal in the scheme was Goldman, Sachs research analyst Eugene Plotkin.

Further investigations by SEC revealed that Plotkin and Pajcin were directing a scheme that involved a large group of unlikely co-conspirators who either illegally tipped inside information to others, or traded on the tips, and then shared in the trading profits. Chief among them was a mergers and acquisitions analyst at Merrill Lynch, who is alleged to have provided nonpublic information regarding pending corporate transactions. Two other individuals allegedly obtained jobs at a Wisconsin printing plant in order to steal information on Business Week articles before the magazine was circulated. Pajcin and Plotkin also allegedly obtained information from a letter carrier who was sitting on a federal grand jury in New Jersey regarding the grand jury's probe of a public company. Pajcin and Plotkin will then circulate the stolen information to a broad network of cooperating traders throughout the United States and Europe, including Pajcin's aunt, the retired Croatian seamstress, and a friend employed as an exotic dancer in New York.

In the just filed case of *SEC v Shane Bashir Suman & Anor*¹⁶ it was alleged that the defendant learned about secret merger negotiations through access he had to electronic data in his job as an information technology specialist at MDS Inc, and then gave that information to his wife. In the days before the tender offer became publicly known, the couple made over \$1 million by trading in the securities of the company.

In all these cases, and more, it is abundantly clear that old fraud of insider trading has resurfaced in a new context, albeit the sharing or passing of inside information on the internet. It will appear, however, that there is an increasing pattern of fraud being carried on by the middle/lower echelon of corporate staff, facilitated by internet technology which made confidential information more accessible and thus vulnerable to abuse, then the former pattern of fraud which was almost exclusively being perpetuated by the top echelons of the company. In other words, the internet, by its admirable edge of giving access to greater information, had simply allowed more people to join the bandwagon of fraudsters!

6. A NEW REGULATORY SCHEME FOR AN OLD TRICK

To the extent that the internet provides for revolutionary methods of undertaking securities trading, this raises real fears that insider trading in this new order may not be well

¹⁵ See, U.S. SEC Litigation Release No. 19775/ July, 2006 available at www.sec.gov/news/press.

¹⁶ See U.S. SEC Litigation Release No. 20203/ July 24, 2007 available at www.sec.gov/news/press.

covered by regulations that were essentially made for analog markets. This led a regulator to thoughtfully comment:¹⁷

We stand on the brink of a new millennium and our markets... are experiencing explosive change, particularly as a result of technology. It is fair to ask how the new online markets fit into a structure of regulation originally designed for an off-line world. Should we address these changes in our markets through a new regulatory scheme or through enforcement of existing rules in a manner that is consistent with their prohibitions yet responsive to evolving conditions?

It is submitted that the answer to this question is not clear cut. This is because the process of enforcement itself must necessarily be dynamic. It must strive to respond to the market as well as to legal and technological developments.

On the one hand, it is common place that the internet has spawned new techniques for facilitating fraud. Thus, it has been vigorously argued that fresh regulations should be developed as the old regime guiding an analog market may well have become obsolete and ineffective¹⁸.

On the other hand, it has been said that drafting and adopting effective new rules typically requires the study over time of a particular type of pattern of misconduct, followed by a lengthy notice and public comment period. Inevitably, by the time the rules become operative, the crooks had moved on. Again, specific regulatory prohibitions are static, and inevitably reflect assumptions – and limitations – prevalent at the time of their adoption, but not necessarily in the future¹⁹.

In our respectful view, an appropriate balance could, and should, be struck between a proactive enforcement of the existing law, and making of new regulations, where an unforeseeable the need arises. It is our respectful view that under Section 265 of ISA, which defines a security as any of the listed type of investment assets and instruments, including those “...which may be transferred by means of any electronic mode approved by the commission insider trading remains a securities market abuse in Nigeria, online or offline.

7. CONCLUSION AND RECOMMENDATIONS

Insider trading, as we have seen, is trading in a company's securities for personal gains by its officials or other interested parties on the basis of confidential “price-sensitive” information that was obtained solely by reason of their relationship with the company, and breach of their fiduciary duties with regard to the use of such information.

Manifestly, the internet has opened new vistas in securities trading in that it offers securities operators an excellent opportunity to reach more people, more quickly, with more information at a lower cost than before. It also gives investors more access to invaluable information than before.

However, and quite unfortunately, it had also facilitated the circulation of confidential corporate information thus increasing the army of insider dealers in Nigeria though, it will appear that the system of internet trading of securities is yet to be recognized. Although some of the securities operators use the internet to advertise their services and products to potential investors, actual trading of the securities is only done on the floor of the Nigeria Stock Exchange with the attendant multiple transaction costs.

¹⁷ Speech by Richard H. Walker (Former Director of Enforcement, U.S. SEC entitled “Regulations v. Enforcement in an online world” delivered at The Bond Market Association's 6th Annual Legal Compliance Seminar. New York. October 25, 2000 available at www.sec.gov/news/speech.

¹⁸ See Austen-Peters A.O., *Op. cit.*, n 12, p. 464.

¹⁹ See Richard H. Walker, *Op Cit.*, n 17.

It is therefore respectfully submitted that, in view of the considerable advantages that the internet has to offer (earlier outlined in this paper), it is time of the Capital Market authorities to introduce and embrace this system in Nigeria, taking as much as possible into cognizance its inherent problems as well as local customs and peculiarities in securities trading in Nigeria.

Be that as it may, whilst, as we have seen, the Western world has taken a committed stance against the practice of Insider trading, and had recorded considerable success in combating this abuse, it is disheartening to note that the Securities and Exchange Commission (SEC) that is statutorily empowered to do the job here in Nigeria has barely taken this responsibility seriously. Although, the ISA has been enacted since 1999, a decade ago, up till date there has been no single reported instance of insider trading prosecution in Nigeria. *Does this mean that our (analog) securities market is entirely devoid of insider trading practices?* This unsatisfactory state of affairs made a learned author to sadly lament that²⁰:

The war against insiders, as it is now, is merely a statutory one where the Investment and Securities Act and its precursor, the Companies and Allied Matters Act have made a number of bold innovative provisions designed to check insiders. But, there remains to be seen an infrastructural machinery for the enforcement of the regulations by an aggressive and effective monitoring, investigation, detection and punishment of insider traders in our capital market.

For SEC to live up to its statutory responsibility of protecting the security market from insider trading, we recommend that the following steps be urgently taken:

1. SEC should reorganize its priorities, and reshape its focus as the apex securities market enforcer if the fight against insider trading is to be taken seriously in Nigeria. Reference could be made to the situation in the U.S. where investigating and prosecuting insider traders has remained an enforcement priority for U.S SEC for more than 70 years. Recent statistics show that in the 5 year period between 2001 to 2006, it filed charges against over 600 individuals and entities for insider trading violations, and froze millions of dollars illicit trading proceeds²¹
2. Apart from monitoring individual compliance, SEC's work should extend to monitoring entities that should shoulder primary responsibility for supervising professionals that work for them. i.e. SEC should monitor level of anti-insider trading that exists in companies.

For instance, in 2006 the U.S. SEC instituted administrative proceedings against Morgan Stanley Inc. for its failure to maintain and enforce adequate written policies and procedures to prevent the misuse of material non-public information by the firms or persons associated with them. Although, there was no evidence that materials non-public was misused as a result of that failure, the company agreed to pay \$10 Million on civil penalties, as well as engage an independent consultant to conduct a review of its policies, practices and procedure and to recommend changes to those policies to prevent the future abuse of such non-public information²².

3. SEC should make regulations mandating Directors, Officers, and those categories of staff that have access, ordinarily, to unpublished price sensitive information to disclose their shareholdings in the company every 6 months. The level of these

²⁰See Abugu J.E., Op. cit., n 1, p. 260.

²¹See an extract of the Testimony concerning Insider Trading by Linda Chatman Thomsen (Director of Enforcement, U.S. SEC) before the U.S. Senate Committee on Judiciary. September 26, 2006 available on www.sec.gov/new/testimony

²² See Testimony concerning Insider Trading by Chatman Thomson (Director of Enforcement, U.S. SEC) before the U.S Senate Committee on Judiciary. September 26, 2006 available on www.sec.gov/news/testimony

holdings should be kept under close scrutiny, especially in the few weeks before the Annual General Meeting of the company when inside trading reaches its feverish pitch. It will be quite easy to fish out perpetrators within this period.

4. SEC should eliminate the information asymmetry between the insider and the investing public. For instance, the accounts and result of quoted companies are usually released to stockbrokers before the general public. It is submitted that this practice may encourage insider trading from the employees of the stockbroker²³.
5. Brokers/Dealer firms should pay particular attention to particular orders from clients in companies, where such clients are Directors, Officers and employees, or are retainers of such companies. Furthermore, the management of such Broking firms are expected to diligently guard all material information about companies which may be in their possession, as to prevent insiders dealings in the securities of such company by their own staff.
6. On the ISA, sanctions for the offence of inside trading are either civil, criminal or both. As most allegations of insider dealings are based largely on indirect or circumstantial evidence, the law enforcement system needs to concentrate more on civil penalties in order to enforce the laudable provisions of the ISA. This would, obviously, also help in eliminating the problem that would be presented by establishing the criminal burden of proof²⁴.
7. There is also the pressing need for a closer collaboration between SEC and the Attorney General's office as regards the successful enforcement and prosecution of insider traders. As the Attorney-General is responsible for the enforcement of all federal laws, and law stands now, criminal prosecution is the constitutional responsibility of the Attorney General's office. Where the goals of the 2 bodies diverge, problems arise. As the not just securities law, enforcement problems will linger if the Attorney General has other pressing priorities other than the prosecution of insider trading violators.

²³ Idigbe, A. I. (SAN), *Legal Issues in Capital Market Operations in Nigeria*. (Lagos: Distinct Universal Press, 2006) p. 70.

²⁴ See Abugu J.E., *Op.cit.*, note 20, p. 258.