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QST LA245 H1

24 April 2019

Industry Analysis of The U.S. Finance Industry

U.S finance industry is undoubtedly a giant in the world. According to Nasdaq, “the U.S. stock market is currently \$34 trillion, compared to the rest of the world’s \$44 trillion capitalization.”¹ In such an industry, participants are generally considered successful, as most of them have prestigious college degrees and valuable working experiences. Also, many industry players and executives are extremely wealthy and make considerably more than top executives in some other leading industries, such as corporate services and legal services. The finance industry ranks fifth among the top ten highest paying industry, while consumer goods industry ranks sixth and construction industry ranks seventh. High income makes people desired to step in the finance industry.²

Important players in the finance industry include credit unions, banks, credit-card companies, insurance companies, accountancy companies, consumer-finance companies, stock brokerages, investment funds, individual managers and some government-sponsored enterprises.

¹ Surz, Ron, “U.S. Stock Market Is Biggest & Most Expensive In World, But U.S. Economy Is Not The Most Productive”, *Nasdaq*, April 02, 2018, <https://www.nasdaq.com/article/us-stock-market-is-biggest-most-expensive-in-world-but-us-economy-is-not-the-most-productive-cm942558>

² Strauss, Karsten, “The Best-Paying Jobs And Industries In the U.S.”, *Forbes*, September 06, 2017, <https://www.forbes.com/sites/karstenstrauss/2017/09/06/the-best-paying-jobs-and-industries-in-the-u-s/#7010c2975038>

Morgan Stanley, J.P Morgan, Goldman Sachs, and HSBC are well-known representatives of this industry.

Nowadays, finance practitioners are facing various kinds of lawsuits. The nature of businesses in finance companies makes them susceptible to regulations, because most of them are public companies. U.S. News states that Banks and financial services institutions “must comply with — and can also easily be accused of violating — any number of laws, including federal and state securities laws, Dodd-Frank, the Bank Secrecy Act, the Patriot Act, Credit Card and Consumer Protection laws, Truth in Lending, Equal Credit Opportunity, Fair Credit Reporting Act, and Fair Debt Collection Practices Acts.”³

The finance industry is always complex, inaccessible, and secretive. It is an industry that has a relatively high cost of entry and is filled with complicated methodologies. However, methodologies are built by people, and people are imperfect. When there are conflicts of interests or temptation, industry participants may make illegal decisions. Numerous lawsuits have emerged as a result of scandals in the finance industry that have impacted businesses and alerted government overseers. Many of these scandals involve insider trading.

Referring to SEC’s definition, illegal insider trading is “buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material, nonpublic information about the security.”⁴

According to the textbook’s chapter on tort law, “if the defendant could foresee that misconduct would injure a particular person, he probably has a duty to her.” To win a negligence

³ Sama, Vincent, et al. “Litigation - Banking & Finance”, *U.S. News*, <https://bestlawfirms.usnews.com/litigation-banking-finance/overview>

⁴ SEC, “Fast Answers”, *SEC*, May 16, 2018, <https://www.sec.gov/fastanswers/answersinsiderhtm.html>

case, a plaintiff must prove five elements, which are the duty of due care, breach, factual cause, proximate cause, and damages. For the first one, insider trading activities violate special duties as professionals, because traders have “a heightened duty of care” and should act as reasonable traders. For the second element, it is obvious that insider trading activities failed to meet legal obligations, such as keeping information confidential. For the third and fourth element, courts have to look at two separate causation issues: was the defendant’s behavior the factual cause or the proximate cause of the harm? In the case of insider trading, one factor that may make defendants liable for breaching the duty of care is if they reasonably foresaw damages, which is the proximate cause. For the last one, it is reasonable to expect that the plaintiff will suffer a measurable loss from insider trading activities. In conclusion, insider trading activities are qualified and very likely to be sued for negligence under tort law.⁵

As responses to insider trading activities, SEC filed several regulations against this specific type of illegal activity. Most of them are based on statutes. First, U.S. insider trading prohibitions are based on English and American common law prohibitions against fraud. Furthermore, section 15 of the Securities Act of 1933 contained prohibitions of fraud in the sale of securities, later greatly strengthened by the Securities Exchange Act of 1934.⁶⁷ Section 16(b) of the Securities Exchange Act of 1934 prohibits short-swing profits (from any purchases and sales within any six-month period) made by corporate directors, officers, or stockholders owning more than 10% of a firm's shares. Under Section 10(b) of the 1934 Act, SEC Rule 10b-5,

⁵ Beatty, Jeffrey, et al. “Legal Environment 7th Edition“, *Cengage Learning*, January 1, 2018.

⁶ SEC, “The Laws That Govern the Securities Industry”, *SEC*, Oct. 01, 2013, <https://www.sec.gov/answers/about-lawsshtml.html#secact1933>

⁷ SEC, “The Laws That Govern the Securities Industry”, *SEC*, Oct. 01, 2013, <https://www.sec.gov/answers/about-lawsshtml.html#secexact1934>

prohibits fraud related to securities trading. The Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 place penalties for illegal insider trading as high as three times the amount of profit gained or loss avoided from the illegal trading.

⁸ Illegal insider trading is also regulated by SEC through its “Fair Disclosure” and its rules on takeovers and tender offers under the Williams Act.⁹

Apart from SEC, the department of justice (DOJ) can also participate insider trading investigation if SEC has initiated its investigation. Furthermore, the financial industry regulatory authority (FINRA) is monitoring insider trading activities and ready to share information with both federal and state level authorities.¹⁰

Companies also have internal regulations against insider trading, and measures include having “blackout periods when officers, directors and other designated people are barred from purchasing the company's securities, usually around earnings announcements.” Some companies now require officers, directors and others to clear their purchases or sales of the company's securities with its chief legal officer (CLO) to avoid any conflicts of interest or violations of securities laws. Last but not least, other companies implemented an education program for their employees in which they could learn how to avoid insider trading or sharing material nonpublic information.¹¹

⁸ Thomsen LT, “Testimony Concerning Insider Trading”, *SEC*, September 26, 2006, <https://www.sec.gov/news/testimony/2006/ts092606lct.htm>

⁹ Larry Harris, Chapter 29 “Insider Trading”, *Trading & Exchanges*, *Oxford Press*, Oxford, 2003.

¹⁰ Pavlo, Walter, “Insider Trading: Civil Or Criminal Crime?”, *Forbes*, October 24, 2013, <https://www.forbes.com/sites/walterpavlo/2013/10/24/insider-trading-civil-or-criminal/#37808e526564>

¹¹ Sebastian, “How Insider Trading Is Prevented in Corporations”, *Investopedia*, Oct. 13, 2018, <https://www.investopedia.com/articles/investing/092616/how-insider-trading-prevented-corporations.asp>

Based on my interview with Yuxiang Zeng, an BU alumni and an associate of PwC Beijing Advisory Services, I am convinced that insider trading is present in the finance industry nowadays. In our conversation, he mentioned that PwC required all incoming employees who would deal with confidential work to take training courses. One of the courses clearly states that insider trading is prohibited, and anyone involved will be immediately dismissed. Moreover, all projects are confidential from the beginning to the end. If insider trading is detected, all project participants' communication records, including phones, emails and social media accounts will be investigated. When I asked him about approaches to investigate when insider trading happens without any communication records, he explained to me with an example: if a company is going to be public (IPO), and someone buys in large amount of stock just before public listing, investigators will then look for information of the buyer and probably find out relationship between the buyer the inside trader.¹²

Noticeably, penalties on insider trading can vary from being jailed or only being fined. A former Assistant Director and Assistant Chief Litigation Counsel in the Division of Enforcement at the SEC claims that “trigger for criminal trading charges” are based on three primary factors, including “significance of wrongdoing (amount of money involved, the number of people affected by the trade and the duration of the activity)”, “corroboration of others to prove a criminal case and provide evidence of wrongdoing (need someone to flip or have someone on tape)”, and “recidivists of any securities violations (always looking to clean up Wall Street).”¹³

¹² Zeng, Yuxiang, April 17, 2019.

¹³ Pavlo, Walter, “Insider Trading: Civil Or Criminal Crime?”, *Forbes*, October 24, 2013, <https://www.forbes.com/sites/walterpavlo/2013/10/24/insider-trading-civil-or-criminal/#37808e526564>

Admittedly, the U.S. finance industry is facing challenges brought by insider trading activities. However, authorities such as SEC, DOJ and FINRA are unceasingly combating these activities. Tort law, and specifically, negligence law can also be used against insider trading activities. Additionally, industry representatives, such as PwC, have implemented internal approaches to prevent employees from engaging with such activities.

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