
# Re-examining Expert Networks: A New Perspective

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Abstract:

Expert networks play a legal and useful role in investment research, but have been implicated in several recent civil and criminal insider trading prosecutions. Although compliance enhancements have been implemented since these prosecutions, the response of the industry has been to add restrictive and somewhat arbitrary controls that do not sufficiently alter the risk profile of the interactions, and limit the dissemination of legitimate information. The secrecy of the consultation between the expert and his or her client remains a critical weakness in the current system.

To mitigate this weakness, expert networks should become more transparent. By integrating technology and broad public access into these interactions, an important step can be taken to reduce the risk while enabling the valuable exchange of information in these networks within a compliant environment. Slingshot Insights' expert network model provides a method for this approach. By recording and making available online all expert interviews, Slingshot's model is more transparent and public than current expert network practices, reducing the need for arbitrary and limiting compliance restrictions, while simultaneously enhancing expert network compliance.

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For many years the SEC's website featured a famous quotation from Louis Brandeis: "Sunlight is said to be the best of disinfectants; electric light the most effective policeman. . . If the broad light of day could be let in upon men's actions, it would purify them as the sun disinfects."[1]

Over the past decade there has been an increased focus on expert networks from both regulators and the media. After several well publicized prosecutions involving information that was conveyed through expert networks, compliance departments have tightened policies with the goal of preventing the disclosure of material nonpublic information and avoiding regulatory scrutiny.

However, it is time to consider improvements in the current workings of expert networks and re-examine the situation with a fresh perspective. Instead of the previous "secrecy" approach - where the consultation between the expert and his or her client occurred orally, on a one-on-one basis, and without any third-party observation - the simple answer may be to let the "sunlight" in on these expert consultations.

## I. The Legitimate Value of Expert Networks

Many users of information cannot retain valuable experts as full time employees. Instead, they must seek out and retain experts on an as needed basis. Expert networks identify and make available experts on demand to fill this gap. "The term 'expert network' is used to refer to firms that are in the business of connecting clients, principally institutional investors, with persons who are deemed to have special expertise in the client's area of interest. Experts can include academics, scientists, engineers, doctors, lawyers, suppliers, and professional participants in the relevant industry, including in some cases even former employees of the company of interest. These networks can save investors the time, cost, and uncertainty associated with obtaining specialized knowledge on their own. If used properly, **expert networks can be a valuable and legitimate research tool that facilitates efficient access by clients to persons with specialized and valued expertise**."[2]

Expert networks are necessary and provide value to the markets as a whole. Although the recent prosecutions involving expert networks highlight the deficiencies in the historic expert network system, this does not impact the inherent legality of the use of expert knowledge, which has continually been acknowledged by the courts and SEC.

The United States Supreme Court, relying upon observations by the SEC, expressly recognizes the value and legitimacy of research and information gathering that may give one trader an informational advantage over others:

[1] Louis D. Brandeis, "What Publicity Can Do," Harper's Weekly (Dec. 20, 1913).

[2] Bondi and Lofchie, "The Law of Insider Trading," NYU Journal of Law and Business 151, n. 1 (2011)I(emphasis added).

> Imposing [insider trading liability] solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. [Footnote 17] It is commonplace for analysts to "ferret out and analyze information," 21 S.E.C. Docket at 1406, and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. . . . It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.
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> [Footnote 17] **The SEC expressly recognized that "[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors**." 21 S.E.C. Docket at 1406. The SEC asserts that analysts remain free to obtain from management corporate information for purposes of 'filling in the interstices in analysis'. . . ." Brief for Respondent 42 (quoting Investors Management Co., 44 S.E.C. at 646).[3]

The courts also recognize the legality and legitimacy of the "mosaic theory," under which "a skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information."[4] The SEC also expressly recognizes the legitimacy of this theory stating, for example, in the adopting release for Regulation FD, that "an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a 'mosaic' of information that, taken together, is material."[5]

The SEC has explicitly stated that "**it is legal to obtain expert advice and analysis through expert networking arrangements**."[6] Indeed, Carlo Di Florio, the former director of the SEC's Office of Compliance Inspections and Examinations, made clear in a speech on March 21, 2011, that recent insider trading prosecutions do not reflect a hostility by the SEC towards expert networks:

> Contrary to some reports that I have seen, I believe these cases do not represent some inherent hostility by the Commission toward expert networks, nor do they indicate that the Commission is seeking to undermine the mosaic theory, under

[3] Dirks v. SEC, 463 U.S. 646, 658-59 (1983)(emphasis added).

[4] Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980).

[5] Selective Disclosure and Insider Trading, 17 C.F.R. §§ 240, 243, 249 (2000), available at ttp://www.sec.gov/rules/final/33-7881.htm#P22_3882

[6] Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Hedge Fund Managers and Traders in $30 Million Expert Network Insider Trading Scheme (Feb. 8, 2011), available at http://www.sec.gov/news/press/2011/2011-40.htm

> which analysts and investors are free to develop market insights through assembly of information from different public and private sources, so long as that information is not material nonpublic information obtained in breach of or by virtue of a duty or relationship of trust and confidence. . . . . **I am not suggesting that advisers must avoid using expert networks.**[7]

As stated in the Dirks case, the nature of much information is that it cannot simultaneously be disclosed to all investors; however, this does not mean information dissemination should be limited beyond what is necessary. In an ideal world where value is assigned to information and efficient pricing, broader distribution of information and greater information parity are desired goals.

## II. Compliance Gaps in the Historic Expert Network System

Recent highly publicized criminal prosecutions have highlighted the weaknesses in the historic expert network system. In one such case, according to the indictment, Mathew Martoma obtained and then traded on confidential information about a drug trial from a University of Michigan professor, Dr. Sidney Gilman, who was consulting on the trial. The professor allegedly swapped information with Mr. Martoma through "paid consultations that . . . were arranged by a New York-based expert-network firm." Martoma was convicted after trial and sentenced to nine years imprisonment. Martoma's employer at the time was also charged both criminally and civilly because of the conduct of certain of its employees, including Martoma, and settled by paying almost $2.5 billion in monetary penalties.

In another insider trading case involving expert networks, the government alleged the following:

> This case involves insider trading by ten individuals and one investment adviser entity, all of whom are consultants, employees, or clients of the so-called "expert network" firm, Primary Global Research LLC ("PGR"). Longoria, DeVore, Jiau, and Shimoon were all employed by technology companies and also served as PGR consultants, or "experts," who used their access to material nonpublic information regarding technology companies to facilitate widespread and repeated insider trading by numerous hedge funds and other investment professionals. Each obtained material nonpublic information about sales, earnings, or performance data, concerning various public companies, and shared that inside information with hedge funds and other clients of PGR who traded on the information. Each also received cash compensation from PGR in return for providing the inside information. Fleishman and Nguyen were PGR employees who facilitated the transfer of material nonpublic information from PGR consultants to PGR clients and, in certain instances, acted as conduits by receiving material nonpublic information from PGR consultants and passing that information directly to PGR clients. Barai, Pflaum, Barai Capital, Freeman, and Longueuil were among the recipients of the material nonpublic information

[7] Speech by Carlo DiFlorio, (March 21, 2011), available at http://www.sec.gov/news/speech/2011/spch032111cvd.htm

supplied by PGR consultants and employees, and either traded on the information or directly or indirectly caused hedge funds they managed or were otherwise affiliated with to trade based on the information.[8]

The SEC particularly alleged in this action that the secrecy of the expert consultations was a critical aspect of the alleged misconduct:

- "When soliciting consultants for PGR, he [Fleishman] made clear that their telephone conversations with PGR clients would not be monitored or recorded."[9]
- "To assuage prospective clients' concerns that this illegal activity would be detected, Fleishman assured them that PGR would not monitor or record their calls with the PGR experts."[10]

These insider trading cases resulted in significant penalties for many of those charged, including significant periods of incarceration, although a few of the defendants avoided imprisonment by cooperating with the government in its prosecutions of others.

As these cases illustrate, and many other illustrations can be found,[11] experts have allegedly been used by money managers to obtain material nonpublic information subject to confidentiality obligations. This has led to prosecutions with devastating impact on the reputations of firms and extremely harsh penalties for individuals.

In response to these prosecutions, expert networks have made efforts to enhance their compliance systems to address regulatory concerns. For example, former OCIE Director Carlo Di Florio has recommended certain compliance procedures for expert networks and their customers.[12] Expert networks have made efforts to screen experts before retention, to train them on legal requirements, and to impose contractual obligations upon them.

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[8] SEC v. Longoria, et al (S.D.N.Y. Feb. 3, 2011), available at https://www.sec.gov/litigation/complaints/2011/comp-pr2011-40.pdf

[9] Id., page 10, paragraph 38.

[10] Id., page 11, paragraph 41.

[11] The SEC has published a list of such cases filed since 2009. http://www.sec.gov/spotlight/insidertrading/cases.shtml

[12] Speech by Carlo DiFlorio (March 21, 2011), id., "Front-end controls could include such things as reviewing the terms of agreements with expert network firms, having adviser staff read and acknowledge the adviser's insider trading policies, and pre-approving every conversation with an expert. It might mean having, at least occasionally, "chaperoned" conversations -- that is, a compliance person is a silent listener to the conversation between the expert and the adviser's money manager/analyst. The adviser might also want to conduct an evaluation of the controls that are in place at expert networks with which the adviser does business. The adviser might also want to either avoid being involved with an expert who is an employee of a public company, or having extra controls in place."

http://www.sec.gov/news/speech/2011/spch032111cvd.htm (emphasis added).

At first glance, it may seem that these restrictions have "reformed" the expert network industry. However, despite all of the compliance efforts, an unresolved gap remains in the compliance system for expert networks - the secrecy of the communication between the expert and the client. The actual communication between the expert and the user is usually oral, is usually unsupervised, and is usually unrecorded. The conversation between the expert and the user is only selectively monitored by a legal or compliance officer because it is too time consuming and disruptive to the legal or compliance officer's daily schedule to chaperone every such conversation.

Because of the secret nature of the typical conversation between the expert and the client, if improper information is conveyed by the expert, this is usually unknown until it is too late, after illegal trading has occurred and prosecution is imminent. The private nature of the communication between the expert and the user also can embolden the expert who wishes to convey information improperly. The customer may also be emboldened by the private nature of the communication to induce the expert to convey information improperly. Indeed, in the Primary Global case, described above, the secrecy of the expert consultations was actually used as a sales point to induce prospective clients to retain the experts.

Ultimately, the system permits a couple of "bad seeds" to limit the dissemination of information while retaining a system that can still be exploited by individuals who choose to do so. In order to achieve maximum value of expert consultations and thus more efficient pricing of securities, a system should be designed to support the best quality of expert consultations with the lowest risk of material non-public information being disclosed. It is time to consider what additional tools are available to improve compliance and risk mitigation in expert networks.

## III. Reimagining Access to Expert Insights in a Technology Driven Society

When reimagining expert network compliance one must consider how technology can reduce illegal conduct and provide a greater number of investors with access to information. We live in a time where it has never been easier to access information; over 3 billion people have access to the internet and social media connects the world. In contrast, in 1995 only 1% of the world's population had access to the internet.[13] As the world evolves, expert networks can take advantage of these technological advances, recording and transcribing expert calls and making them available online to a larger group.

Recording the consultation between the expert and the user and posting it online, making it available to a larger community of analysts and investors, would bring transparency to all such communications. On the premise that "sunlight is the best disinfectant," this step, by itself, should deter an expert from revealing information improperly and also should reduce the temptation of an investor to coax the expert to reveal information improperly.

This compliance solution also has potential economic benefits. First, with more participants, the cost for each call is reduced, thereby increasing the total number of participants that can access the information. This allows a larger group of investors to "ferret out" information, working independently to draw conclusions. Second, recorded calls and transcripts

[13] http://www.internetlivestats.com/internet-users/

eliminate the repetitive nature of the calls thus limiting the opportunities for an expert to mistakenly disclose information; a single call can replace what was previously dozens of repetitive interviews.

Additionally, having online call recordings and transcripts should permit the user's compliance officer efficiently to monitor expert consultations after the consultation so that any improper conversations can be addressed quickly. In this proposed system, the "sunlight" concept would be a facet of every call. This contrasts starkly with the current system where compliance officers and regulators spot check expert network consultations at random. And, as has been dramatically illustrated in the recent prosecutions arising from expert consultations, the potential loss of secrecy in the communication between the expert and the client does not outweigh the compliance benefits.

Finally, enhanced transparency may also permit the communication of information that other models currently bar. For example, some expert networks arbitrarily bar consultations with an expert about a company for a full year after the expert has left the employ of that company. This arbitrary rule reduces certain compliance risks, but also potentially deprives customers of useful information that could be obtained legally. In addition, because of the compliance risks associated with the current expert network system, many clients of the expert networks have imposed individually tailored restriction of the consultations, which creates a system that is needlessly inconsistent and complex. In the proposed model, additional legal information can be conveyed because of the greater transparency and compliance protection that a more transparent model provides.

## IV. Utilizing Technology to Channel the "Sunlight" of a Crowd

Slingshot Insights offers an approach to expert networks that incorporates the "sunlight" concept.

Slingshot Insights publicizes the expert interview in advance and attempts to recruit as many participants in the expert consultation as possible, removing the veil of secrecy that is often associated with expert calls. All calls are systematically recorded, transcribed, and stored on the site for access at any time. It is a feature of the system, not an option for the customer. This information is available to the public at large as anyone can sign up for the site for free, and users that wish to participate on a call or access executed calls can do so for a clearly defined fee.

With this approach to expert networks, a self-policing community is created. Material nonpublic information subject to a confidentiality obligation is less likely to be divulged in a public forum that is recorded with multiple parties in attendance. Slingshot Insights also provides the ability for all members and their compliance officers to flag any project in which confidential information is suspected to be shared. These flags are visible to all users who are advised to trade at their discretion.

Slingshot also may permit the communication of information that other models currently bar. As Slingshot's model is by nature more transparent and public, there is less need arbitrarily to restrict the dissemination of expert knowledge out of fear that there will be disclosure of

material nonpublic information subject to a confidentiality obligation. This results in investors having more access to information to inform their investment theses.

The deficiencies recent criminal convictions have exposed in the historic expert network system have rightly served as a moment of reflection for the industry. However, the steps taken by existing networks to promote compliance have resulted in a system that does not fully address the underlying compliance gap in the expert network model and arbitrarily restricts dissemination of legitimate information. The system created by Slingshot Insights is one solution that uses technology and innovation to enhance expert network compliance and address the yet to be closed gap in that compliance.