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How To Avoid The Pitfalls Of Expert Networking

Law360, New York (April 20, 2011) -- Recent insider trading prosecutions in the Southern District of New York have drawn attention to the use of "expert networking" firms as potential conduits for unlawful trafficking in inside information. For example, the indictment in United States v. Jiau, No. 11 Cr. 161 (JSR) (S.D.N.Y. filed Mar. 8, 2011), charges a consultant used by one of the networking firms — and that firm's hedge fund client — with unlawfully trading on inside information allegedly obtained from employees of high-tech companies.

A companion civil suit filed by the U.S. Securities and Exchange Commission makes similar allegations against the consultant and two employees of the expert networking firm, as well as several more of its clients. Amended Complaint, SEC v. Longoria, No. 11-CV-0753 (JSR) (filed Feb. 8, 2011).

The SEC's press release about its amended complaint in the civil suit states that "it is legal to obtain expert advice and analysis through expert networking arrangements."[1] Notwithstanding such assurances, in the current environment, investors and others may well think twice before using such firms for fear of running afoul of insider trading prohibitions. This article considers that risk and offers some suggestions for minimizing it.

Because expert networking firms are probably less familiar to most lawyers than they are to their clients in the hedge fund, private equity and financial services areas, the article first reviews the common characteristics and uses of such firms. Next, it summarizes the basic prohibition against tipping, the form of insider trading alleged in the Jiau and Longoria cases. The article then suggests elements of a compliance policy applicable to the use of such firms.

The Characteristics and Uses of Expert Networking Firms

Expert networking firms identify persons knowledgeable about given businesses, industries, technologies and other matters who are willing to act as consultants to investors, and then offer investors access to those individuals in exchange for a fee, which is shared with the consultant.

Investors, particularly hedge funds and private equity firms, often contract to obtain a specified number of consultations over a given time period such as a year. The basic services performed by the expert networking firm are the identification and qualification of consultants who suit the investor's needs.

Expert networking firms can be an important element in the research and due diligence processes of sophisticated investors. They can facilitate intelligence gathering such as "channel checks," in which, for example, independent distributors of a company's product are interviewed to obtain information about the product's performance in the marketplace. They may also connect an investor with experts in a scientific or technical area — for example, sources and uses of rare earth elements — that may help in developing an investment idea or strategy.

A consultant made available by an expert networking firm may also provide information of a more subjective sort that an investor could not readily obtain elsewhere, such as assessment of the strengths and weaknesses of particular managers or products, or predictions about the effects of a government program.

Because expert networking firms can provide investors with information very rapidly, they can confer a distinct competitive edge. The industry has grown substantially in recent years.

Where there are investors searching for information, there is a risk of insider trading, and specifically of "tipping," i.e., the provision of inside information about a company to noninsiders ("tippees") who trade on it. To assess the magnitude of that risk in the expert networking context, it is useful first to review the nature and scope of the prohibition against tipping.

The Elements of Tippee Liability

To make out a case of tippee liability under the traditional theory, the government must show that material, nonpublic information held by a company insider has been disclosed, in breach of a fiduciary duty or similar relationship of trust and confidence, to another, the tippee, who traded based on the information and who knew or should have known that the disclosure was made in breach of such a duty.[2]

The materiality element requires that the information be of a type that a reasonable investor would consider important in making an investment decision.[3]

The duty not to disclose may arise from a number of sources, ranging from the duty an employee owes an employer to the terms of a nondisclosure agreement.[4]

The "scienter" ("knew or should have known") element is satisfied by showing either conscious misbehavior (the recipient actually knows that the information was wrongfully disclosed) or recklessness (the recipient ignores indicia tending to show that disclosure was wrongful).[5]

A personal benefit to the insider from disclosing the information must also be shown.[6] The allegations in United States v. Jiau exemplify this theory. There, the government alleges that insiders at public companies, acting in breach of duties of trust and confidence applicable to them, passed material, nonpublic information to a consultant affiliated with an expert networking firm, who then passed the information on to clients of the firm to enable them to trade on it. SEC v. Longoria alleges that employees of the expert networking firm were also directly involved in such activity.

Managing Potential Risks

Does the use of expert networking firms carry an inordinate risk of insider trading liability? By and large, it should not. As at least one senior SEC staff member seems to have acknowledged, the arrangement alleged in the Jiau and Longoria cases, where expert networking firm employees and consultants allegedly harvested material, nonpublic information from company insiders and then sold it to the networking firm's "select" clients, is not the customary business model of expert networking firms.[7]

As that same SEC representative has also stressed, however, organizations that use expert networking firms should be sure that their own compliance policies address the limits of expert information gathering.[8] Key elements of such a policy are discussed below.

As a first step, investors who wish to use an expert networking firm should become familiar with the compliance policies of that firm. Expert networking firms typically do maintain compliance policies that are described in detail on their websites. A prospective client of such a firm should review the firm's compliance policy before retaining it, and should find out how the firm enforces its policy. One key feature of such a policy is a provision barring consultants from providing consultations about their current employers.

An investor need not deal with an insider directly to become a tippee, however. There are many cases in which the tippee is two or more levels removed from the source of the inside information. In such cases, the key is whether the investor knew or should have known that the information was obtained in breach of a fiduciary or other duty of confidentiality. For that reason, a compliance policy relating to networking firms should also address both the provenance of information provided by the consultant and any restrictions on the disclosure of that information.

Thus, in dealing with a consultant supplied by an expert networking firm, the client should first verify that the expert is permitted to provide the requested information. If the expert is offering insight about a former employer, the client should ask the expert to confirm that there are no ongoing confidentiality obligations to the employer, and also make a clear record of the expert's answers.

If the expert is offering information derived from current employment (for example, a dealer or store manager commenting on a manufacturer's products), the client should ask the expert to confirm that the information can be provided without violating obligations of confidentiality either to the employer or, if applicable, to the supplier in question.

Reputable networking firms vet their consultants for issues of this kind before connecting them with clients, but the client should still perform some due diligence at the outset of a particular consultation, and should also keep an appropriate record of the inquiry.

In addition, personnel who interact directly with consultants — many of whom will be relatively junior analysts — should be taught to recognize the permissible limits of expert information gathering. A consultant purporting to offer nonspeculative information about merger and acquisition plans, earnings releases and the like is obviously entering dangerous territory, but the potential impropriety of other disclosures will not be obvious.

Rather than being drawn into extended deliberations about whether particular information is or is not "material," those who interact with consultants should be trained on the principle that receiving nonpublic information about a public company is inappropriate and should institute measures to insure that they do not receive such information.

And finally, those who interact with expert networking firms should be reminded that insider trading is a serious crime with severe penalties, and that where such crimes are concerned — as the recent wave of insider trading prosecutions amply demonstrates — the government has information-gathering capabilities that are, truly, second to none.

Conclusion

Expert networking firms can perform a valuable service to sophisticated investors who seek an informational edge. To minimize any risk associated with the use of such firms, investors should be conversant with the compliance policies of the firms they use and, where appropriate, should adapt their own compliance policies to cover the use of expert networking firms.

In particular, client personnel should be instructed to take appropriate steps to verify that a given expert is in a position properly to provide the information being sought and should be trained to both to identify, and to avoid seeking, information of a type likely to raise insider trading concerns. A reminder of the penalties for insider trading would also be in order.

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The author notes that one of his sons is employed by an expert networking firm.

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[1] SEC Charges Hedge Fund Managers and Traders in $30 Million Expert Network Insider Trading Scheme, SEC Release No. 2011-40 (Feb. 8, 2011).

[2] See generally Dirks v. SEC, 463 U.S. 646, 661-63 (1983).

[3] E.g., Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988).

[4] Dirks, 463 U.S. at 659; United States v. Chestman, 947 F.2d 551, 567-71 (2d Cir. 1991) (en banc); see also United States v. O'Hagan, 521 U.S. 642, 652 (1997).

[5] See, e.g., Dirks, 463 U.S. at 659.

[6] Dirks, 463 U.S. at 663-64. Note that the personal benefit element does not require any tangible quid pro quo, and showing such a benefit is not required for analogous state law causes of action that may apply.

[7] See, e.g., Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations, SEC, Remarks at the IA Watch Annual IA Compliance Best Practices Seminar (March 21, 2011).

[8] Id.

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