

“Expert Networks” Under Investigation: Insider Trading Probe Into The Use of Consultants May “Ensnare” Hedge Funds, Mutual Funds, and Investment Bankers Across the Country

The *Wall Street Journal* reported on November 20 that a far-ranging insider trading probe into the use of outside expert consultants has the potential to “ensnare consultants, investment bankers, hedge-fund and mutual-fund traders and analysts across the nation.” According to the *Journal*, the criminal and civil probe is being conducted jointly by the U.S. Attorney’s Office in Manhattan and the SEC. The probe focuses, in part, on whether material, non-public information was provided by expert consultants to hedge funds and mutual funds. The widespread investigation extends beyond expert networks to include independent research boutiques. The *Journal* reported that one such research firm’s president had been asked by the FBI to record his conversations with the firm’s hedge fund and mutual fund clients. The joint investigation is ongoing, but the *New York Times* has subsequently reported that some charges may come before the end of the year, with the defendants numbering in the double digits. This investigation signals a sharp regulatory and enforcement focus on what has become a routine part of the investment process for hedge funds, mutual funds, and other institutional investors.

The Investment Industry’s Widespread and Increasing Use of “Expert Networks”

The use of outside expert network consultants has been increasing steadily at investment firms for a number of years. According to a recent report by Integrity Research Associates LLC, almost 40% of buy-side investment firms in North America and Europe currently use expert networks – a significantly higher percentage than many other types of alternative and independent research. While many of the early consumers of expert network services were hedge funds, much of the recent growth in the industry has reportedly come from mutual funds, pension funds, and private equity and venture capital firms.

An investment firm’s purpose in retaining these outside experts is to aid in researching or pressure-testing a particular investment thesis, or to help perform a “deep dive” on particular industry sectors or companies. Outside experts may include industry consultants, vendors, doctors, attorneys, suppliers, or past employees or executives of particular companies. Depending on the type of investor and the focus of the inquiry, expert networks can provide investors with various types of services, ranging from offering general market and company background and forecasting macroeconomic trends to setting up meetings with former managers or suppliers of a company.

This Investigation Into The Use of Expert Networks Is Not The First

The current investigation is not the first instance of enforcement authorities inquiring into the use of consultants. Nearly a decade ago, regulators focused on the use of consultants in the context of public biotech companies’ navigation of the FDA approval process. Those inquiries have increased in recent years, and have reached into other markets. There has been recent focus on the use of consultants in analyzing potential merger and acquisition activity. In one high-profile investigation, the New York Attorney General’s Office investigated whether employees at Best Buy, Circuit City and the credit card processor First Data had

improperly provided nonpublic information to hedge fund traders. And earlier this month, a physician involved in a clinical drug trial was charged with criminal and civil violations of the securities laws for allegedly having disclosed confidential information regarding the results of the trial to a hedge fund portfolio manager who then traded on the information (see Ropes & Gray Alert: [The SEC's Insider Trading Case Against a Clinical Trial Physician: Lessons for Physicians, Investors, and Public Companies](#)).

Mitigating The Legal Risks In Using Expert Consultants

As a general matter, the use of expert consultants is entirely lawful. Indeed, collecting and analyzing data provided by consultants is simply part of the diligence process that is fundamentally what asset managers are paid to do. But certain information provided by consultants about a public company or its securities may give rise to potential exposure for misappropriation or tippee liability if a duty of trust or confidence is owed to the source of the information and the information is material and non-public. As the use of experts has increased, many sophisticated asset managers have implemented policies and procedures designed to mitigate the risks in using expert consultants, including in particular, the misuse of material, non-public information. The breadth and specifics of the policies and procedures for any particular firm are, of course, a matter of judgment based on the firm's particular investment and industry focus, and the nature and frequency of their analysts' use of consultants. But some precautions investment managers have increasingly taken include:

- At the time an investment manager is negotiating the operative contract with an expert network, some managers may seek contractual protections, including a commitment that the network's experts will not disclose proprietary information in the course of any discussion with the asset manager, and that the expert network will indemnify the asset manager in the event of any inquiry concerning such contractually prohibited disclosure;
- At the outset of any discussion with an expert consultant, some managers require the expert consultant to attest that he or she is not violating any employment agreements by providing information, and/or that the expert understands that the manager does not wish to receive material, non-public information and does not wish to be restricted from trading in the stock of any particular company;
- Some investment managers restrict the universe of consultants their analysts may use, including, for example, a prohibition on using any former employee who, within the previous 6 months (or a similar timeframe), left the company that is the subject of the manager's research; and
- Some managers have legal compliance staff monitor or "chaperone" conversations between investment personnel and consultants.

In addition, at least one expert network firm has compiled a database of public company policies related to employees' outside consulting or speaking arrangements, which can help institutional investors understand in advance whether there is any potential that an expert is providing advice in a manner not approved by their employer.

Such precautions can mitigate the likelihood of issues arising, and can be critical in defending against an enforcement inquiry. Given the reported breadth of the parallel criminal and civil insider trading investigation that was disclosed on November 20, together with the increasing appetite of regulators for insider trading cases generally, hedge funds, mutual funds and other investment managers should consider reviewing their policies and procedures to ensure they are consistent with industry best practices.

If you would like to discuss any issues pertaining to the use of outside expert consultants or the insider trading investigation, please contact your usual Ropes & Gray advisor.