III. Expert Networks and Insider Trading: An Introduction and Recommendation

A. Introduction

Recent regulatory action reveals that an expert network enabled the "largest insider trading [scheme] ever charged" by the Securities and Exchange Commission ("SEC").[1] According to the complaint, former portfolio manager Mathew Martoma, armed with insider information, induced two investment advisers to sell over $960 million in pharmaceutical securities in a period of eight days.[2] By selling the securities, CR Intrinsic Investors, LLC ("CR Intrinsic"), the preeminent unit of Steven A. Cohen's SAC Capital Advisors,[3] and an affiliated investment adviser allegedly "reap[ed] illicit profits and avoid[ed] losses of over $276 million."[4] While the

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[1] *SEC Charges Hedge Fund Firm CR Intrinsic and Two Others in $276 Million Insider Trading Scheme Involving Alzheimer's Drug*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/news/press/2012/2012-237.htm (last visited Mar. 25, 2013) ("The illicit gains generated in this scheme make it the largest insider trading case ever charged by the SEC. . . . In phone calls that were arranged by a New York-based expert network firm . . . , Dr. Gilman tipped Martoma with safety data and eventually details about negative results in the trial about two weeks before they were made public in July 2008.").

[2] Complaint at 2, 14–16, SEC v. CR Intrinsic Investors, LLC, No. 1:12-cv-08466-VM (S.D.N.Y. filed Nov. 20, 2012) [hereinafter *SEC Complaint*] ("After Martoma received this information, he caused hedge fund portfolios managed by CR Intrinsic as well as hedge fund portfolios managed by an affiliated investment adviser ("Investment Adviser A") not only to liquidate their combined long positions in Elan and Wyeth, worth over $700 million, but also to take substantial short positions, eventually selling over $960 million in Elan and Wyeth securities in just over a week.").

[3] Svea Herbst-Bayliss & Katya Wachtel, *Latest Arrest Shines Light on Cohen's CR Intrinsic Unit*, REUTERS (Nov. 20, 2012, 06:31 PM), http://www.reuters.com/article/2012/11/20/us-crime-insidertrading-crintrinsic-idUSBRE8AJ1L920121120 ("CR Intrinsic, a unit of Steven A. Cohen's SAC Capital Advisors hedge fund, was long considered the crown jewel in the trader's $14 billion empire.").

[4] *SEC Complaint*, *supra* note 2, at 2 ("This massive re-positioning allowed the CR Intrinsic and Investment Adviser A hedge funds to collectively reap illicit profits and avoid losses of over $276 million.").

"massive re-positioning"[5] of nearly one billion dollars pales in comparison to the six billion dollar loss in J.P. Morgan Chase's "London Whale" scandal,[6] Martoma's alleged scheme merits distinction for the complicity of an expert network firm that remained unnamed in the SEC complaint.[7] Despite the firm's key role in connecting Martoma with insider Dr. Sidney Gilman, the SEC did not press charges against the expert network firm.[8]

This article argues that strong compliance programs and well-written contracts protect expert networks against insider trading and regulatory investigations.[9] Providing background, Part B defines expert networks and offers a look into an archetypal expert network firm: the Gerson Lehrman Group.[10] Next, Part C attributes the rise of expert networks to (1) regulatory revisions to disclosure requirements and (2) reformations to investment banking research practices.[11] Then, Part D posits that expert networks are significant, relevant, and legal.[12] Part E recommends that expert networks guard against insider trading with attention to and analysis of the three primary elements of insider trading.[13] Part F shows how strong compliance programs and well-written contracts protect expert networks against insider trading and regulatory investigations.[14] Finally, Part G observes that the financial market adjusts to spreading risk and liability and recommends guarding against insider

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[5] *Id*. ("This massive re-positioning allowed the CR Intrinsic and Investment Adviser A hedge funds to collectively reap illicit profits and avoid losses of over $276 million.").
[6] *See* Dan Fitzpatrick et al., *'London Whale' Sounded an Alarm on Risky Bets*, WALL ST. J., Feb. 1, 2013, at C1 ("The J.P. Morgan Chase & Co. trader known as the 'London whale' tried to alert others at the bank to mounting risks months before his bets ballooned into more than $6 billion in losses, according to people familiar with emails reviewed by J.P. Morgan and a U.S. Senate panel.").
[7] *SEC Complaint*, *supra* note 2, at 2 ("Martoma met Gilman through paid consultations that took place between 2006 and 2008, and were arranged by a New York-based expert network firm.").
[8] *Id*. at 4–5 (showing that the expert network firm is not mentioned under "Defendants" or "Relevant Entities").
[9] *See* discussion *infra* Parts E, F, G.
[10] *See* discussion *infra* Part B.
[11] *See* discussion *infra* Part C.
[12] *See* discussion *infra* Part D.
[13] *See* discussion *infra* Part E.
[14] *See* discussion *infra* Part F.

trading with robust compliance programs and well-written contracts.[15]

B. Expert Networks Defined with a Look into an Expert Network Firm

Expert networks are complex webs circulating money for information.[16] Expert network firms are "Wall Street matchmakers who connect large investors with outside experts."[17] Recalling the introduction, this model casts CR Intrinsic and Mathew Martoma in the roles of large investors and Dr. Sidney Gilman as the outside expert.[18] The previously unnamed Wall Street matchmaker seems to be the Gerson Lehrman Group ("GLG"),[19] one of the largest expert network firms in terms of revenue and number of expert consultants.[20]

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15 *See* discussion *infra* Part G.

16 *See* Gregory Zuckerman & Susan Pulliam, *How an SEC Crackdown Led to Rise of 'Expert Networks'*, WALL ST. J. (Dec. 17, 2010), http://online.wsj.com/article/SB10001424052748704073804576023724091840868.html figure.

17 Evelyn M. Rusli, *Next Up, A Crackdown on Outside-Expert Firms*, N.Y. TIMES (May 11, 2011, 09:11 PM), http://dealbook.nytimes.com/2011/05/11/next-up-a-crackdown-on-outside-expert-firms/ ("The other group has involved expert network firms, the Wall Street matchmakers who connect large investors with outside experts.").

18 *See* discussion *supra* notes 1–8, 17 and accompanying text.

19 *See* Ashby Jones, *Again, Expert-Networking Firm Is at Heart of Insider-Trading Case*, WALL St. J. (Nov. 20, 2012, 12:36 PM), *available at* http://blogs.wsj.com/law/2012/11/20/once-again-expert-networking-firms-at-heart-of-insider-trading-allegations/ ("[P]eople familiar with the matter have confirmed that the firm was Gerson Lehrman."); *Expert Networks & the "Most Lucrative" Insider Trading Case Ever*, INTEGRITY RESEARCH, http://www.integrity-research.com/cms/2012/11/21/expert-networks-the-most-lucrative-insider-trading-case-ever/ (last visited Mar. 25, 2013) ("It appears the expert network mentioned in the SEC complaint was Gerson Lehrman Group (GLG).").

20 BORIS GROYSBERG ET AL., GERSON LEHRMAN GROUP: MANAGING RISKS 1 (Harvard Business School Publishing ed., 2012) (stating that GLG is "the largest expert network firm globally"); *see* discussion *infra* text accompanying notes 58–60.

As an "early participant" and industry leader in the expert network space,[21] GLG is an archetypal expert network firm.[22] Its 300,000 expert consultants,[23] known as "Council Members,"[24] offer expertise in eight practice areas such as consumer goods, financial analysis, healthcare, regulatory affairs, real estate, and technology, media, and telecommunications.[25] Clients of an expert network firm like GLG include mutual funds, banks, private equity firms, and law firms.[26]

When interested clients seek information, clients contact "research professionals" or access an online portal like the GLG Research Management Platform ("RMP").[27] Once GLG matches client and consultant via recommendations by a research professional or the RMP,[28] GLG Council Members, as "independent contractors,"[29] "educate and share insights"[30] with clients through

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[21] *Id*. at 3 ("An early participant in this market, GLG maintained a dominant market share, estimated by Integrity Research in 2009, at 66%.").

[22] *See* discussion *infra* text accompanying notes 23–33.

[23] GROYSBERG, *supra* note 20, at 6. ("GLG's expert network was composed of more than 300,000 consultants . . . .")

[24] *Id.* (explaining that GLG consultants are "known as GLG 'Council Members'").

[25] GERSON LEHRMAN GROUP, http://www.glgresearch.com/ (last visited Mar. 25, 2013) (click on "Practice Areas" and a drop down menu will appear).

[26] *Accounting & Financial Analysis*, GERSON LEHRMAN GROUP, http://www.glgresearch.com/Council/Accounting--Financial-Analysis.html (last visited Mar. 25, 2013) ("GLG's 850+ Clients Include: More than 70% of the world's leading mutual funds[,] 15 of the leading 20 global banks[,] 9 of the leading 10 global private equity firms[,] 5 of the leading 10 AmLaw firms[, and] Fortune 500® Companies in nearly every industry sector, including pharmaceuticals, insurance, chemicals, energy and computer software.").

[27] *See* GROYSBERG, *supra* note 20, at 5 ("In order to gain information on a particular topic via a phone consultation, a client contacted his/her dedicated GLG research professional with the request or accessed GLG's on-line portal, the GLG Research Management Platform (RMP).").

[28] *Id*. ("The client then contacted the Council Member directly to initiate the project discussion.").

[29] *Id.* at 4 ("Council Members were not GLG employees, but independent contractors compensated on a project-by project-basis.").

[30] *Terms and Conditions of Council Membership*, GERSON LEHRMAN GROUP, http://www.glgresearch.com/tandc.aspx (last visited Mar. 25, 2013) [hereinafter *GLG Terms & Conditions*] ("The GLG Councils are groups of

phone consultations, written reports, market studies, and private visits.[31] Guided by fair market value, the Council Members charge from $50 to over $1,000 per hour for phone consultations.[32] Strict adherence to compliance policies prevents disclosures of "material, nonpublic information about a publicly traded company," confidential information, and "investment advice."[33]

C. Regulatory Actions Fueled the Rise of Expert Networks

Two major regulatory actions, Regulation Fair Disclosure and the Global Settlement, fueled the rise of expert networks by increasing demand for information.[34] In 2000, Regulation Fair Disclosure revised issuer disclosure requirements, which inadvertently silenced issuers of security and thereby created greater demand for expert network services.[35] Then, in 2003, the "Global Settlement," a settlement agreement between ten investment banks and various regulatory agencies, intensified this demand by severing the linkage between research and investment banking.[36]

Regulation Fair Disclosure ("Regulation FD") altered issuer disclosure requirements, creating an information void, which

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professionals and consultants in various industries and specialties who educate and share insights with financial and business leaders and other organizations and professionals ("Clients").").

[31] *See* GROYSBERG, *supra* note 20, at 4 ("GLG projects included phone consultations, written reports, surveys, market studies, private visits, seminars and roundtables, along with longer duration and in-depth consulting projects.").

[32] *See id.* ("Hourly rates for consultations ranged from $50 to in the thousands, with a median rate of $350–$400."); Zuckerman & Pulliam, *supra* note 16 ("[Expert network] firms rely on a network of employees and others who sometimes charge $1,000 or more an hour to share information with investors.").

[33] *See* GROYSBERG, *supra* note 20, at 6 ("Key compliance policies included: 1.) Council Members may not disclose material, non-public information about a publicly traded company; 2.) Council Members may not disclose confidential information; 3.) Council Members may not give investment advice; 4) Council Members will be paid to cut off client calls to honor these policies.").

[34] *See* discussion *infra* text accompanying notes 38–52.

[35] *See* discussion *infra* text accompanying notes 38–43.

[36] *See* discussion *infra* text accompanying notes 44–52.

accelerated the rise of expert networks.[37] The SEC promulgated Regulation FD in 2000 to remedy "selective disclosure."[38] Finding that issuers were revealing nonpublic information to analysts and institutional investors before making a full public disclosure,[39] the SEC adopted Regulation FD to "level the playing field for investors."[40] The regulation required issuers that had disclosed material nonpublic information to specific enumerated persons, like securities professionals, to make that information public.[41] When Regulation FD inadvertently silenced issuers, investors looked elsewhere for an "information edge."[42] Expert networks and expert network firms stepped up to fill the void, offering access to information networks illuminated by experts, academic and professional, in virtually any field.[43]

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[37] *See* discussion *infra* text accompanying notes 38–43.
[38] *Final Rule: Selective Disclosure and Insider Trading*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/rules/final/33-7881.htm (last visited Mar. 25, 2013) ("We are adopting new rules and amendments to address the selective disclosure of material nonpublic information by issuers and to clarify two issues under the law of insider trading. In response to the comments we received on the proposal, we have made several modifications, as discussed below, in the final rules. Regulation FD (Fair Disclosure) is a new issuer disclosure rule that addresses selective disclosure.").
[39] *Id*. ("As reflected in recent publicized reports, many issuers are disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public.").
[40] Zuckerman & Pulliam, *supra* note 16 ("Regulations designed to level the playing field for investors inadvertently helped pave the way for a new era of insider trading . . . .").
[41] *Final Rule: Selective Disclosure and Insider Trading*, *supra* note 38. ("The regulation provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information.").
[42] Zuckerman & Pulliam, *supra* note 16 ("Soon, an industry of expert-network firms arose to help investors get an information edge.").
[43] *See* Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J. L. & BUS. 151, 177 (2011) ("Experts can include academics, scientists, engineers, doctors, lawyers, suppliers, and even former employees of the company of interest.").

The Global Settlement intensified the information demand when it reformed industry-wide investment banking research practices by cleaving connections between research and investment banking.[44] SEC enforcement actions alleged that ten top investment firms including Salomon Smith Barney, Merrill Lynch, and Credit Suisse had permitted investment banking departments to exercise inappropriate influence over research analysts.[45] The Global Settlement forced firms not only to physically separate research and investment banking offices but also to prohibit analyst compensation for investment banking activities and analyst participation in investment banking pitches and roadshows.[46] With the backing of the SEC, the New York Attorney General, the North American Securities Administrators Association, the National Association of Securities Dealers ("NASD"),[47] and the New York Stock Exchange,[48]

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[44] Press Release, U.S Sec. & Exch. Comm'n, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003-54.htm [hereinafter *SEC Global Settlement Press Release*] ("The firms will be required to sever the links between research and investment banking . . . .").

[45] *Id.* ("The enforcement actions allege that, from approximately mid-1999 through mid-2001 or later, all of the firms engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts . . . ."). The ten firms were Bear, Stearns & Co. Inc.; Credit Suisse First Boston LLC; Goldman, Sachs & Co.; Lehman Brothers Inc.; J.P. Morgan Securities Inc.; Merrill Lynch, Pierce, Fenner & Smith, Incorporated; Morgan Stanley & Co. Incorporated; Citigroup Global Markets Inc. (formerly known as Salomon Smith Barney Inc.); UBS Warburg LLC; and U.S. Bancorp Piper Jaffray Inc. *Id*. Salomon Smith Barney, Merrill Lynch, and Credit Suisse bore the heaviest penalties amongst the ten firms: $150 million, $100 million, and $75 million respectively. *Id.*

[46] *Id*. (listing the "important reforms" designed to "bolster the integrity of equity research").

[47] In 2007, NASD and NYSE Regulation, Inc. consolidated to form the Financial Industry Regulatory Authority ("FINRA"). Press Release, U.S Sec. & Exch. Comm'n, SEC Gives Regulatory Approval for NASD and NYSE Consolidation (July 26, 2007), *available at* http://www.sec.gov/news/press/2007/2007-151.htm ("The Securities and Exchange Commission today gave final regulatory approval related to the consolidation of the member firm regulatory functions of the National Association of Securities Dealers, Inc. and NYSE Regulation, Inc., a wholly-owned subsidiary of New York Stock Exchange LLC. . . . The

the Global Settlement "dramatically reduced"[49] Wall Street's research "coverage and knowledge base."[50] Investment banking firms, like investors after Regulation FD, sought other sources to satiate its need for information.[51] This information-hungry environment accelerated the growth of expert networks.[52]

D. Expert Networks Are Significant, Relevant, and Legal, but May Toe the Line

Since the rise of expert networks fueled by Regulation FD and the Global Settlement, expert networks are now significant, relevant, and, in spite of notoriety and convictions, legal.[53] Recent

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consolidated organization will be known as the Financial Industry Regulatory Authority, or FINRA.").

[48] *See SEC Global Settlement Press Release*, *supra* note 44 ("Securities and Exchange Commission Chairman William H. Donaldson, New York Attorney General Eliot Spitzer, North American Securities Administrators Association President Christine Bruenn, NASD Chairman and CEO Robert Glauber, New York Stock Exchange Chairman and CEO Dick Grasso, and state securities regulators announced today that enforcement actions against ten of the nation's top investment firms have been completed, thereby finalizing the global settlement in principle reached and announced by regulators last December.").

[49] Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39, 39 (2007) ("Research coverage of small issuers has been dramatically reduced--the vast majority of small capitalization firms now have no coverage at all.").

[50] GROYSBERG, *supra* note 20, at 2 ("After numerous investigations and much debate, the Global Settlement was implemented in 2003, and the Street reduced its coverage and knowledge base . . . ."); *see* Fisch, *supra* note 49, at 39 ("Research coverage of small issuers has been dramatically reduced--the vast majority of small capitalization firms now have no coverage at all.").

[51] GROYSBERG, *supra* note 20, at 2 ("After numerous investigations and much debate, the Global Settlement was implemented in 2003, and the Street reduced its coverage and knowledge base, causing investors to look elsewhere for investment expertise.").

[52] *See id*. ("All of these trends combined to put a premium on good information sources and helped to fuel the expansion of GLG's business."); Bondi & Lofchie, *supra* note 43, at 177 ("In the wake of Regulation FD, and with the growth of private funds, the use of expert networks by institutional investors has grown significantly in recent years.").

[53] *See* discussion *infra* text accompanying notes 54-67.

reports indicate the expert network industry generates revenues upwards of $250 million annually.[54] A Harvard Business School case study reports industry revenues of $433 million in 2008, $364 million in 2009, and $400 million 2010.[55] A related report by Integrity Research Associates pegs the number of expert network firms in 2009 at thirty-eight.[56] Two expert network firms, GLG and Primary Global Research, each gained recent media attention, positive and negative respectively.[57] Already an industry leader based on revenue earning $200 million of the $299 million in the industry in 2006,[58] GLG also leads based on the number of consultants, commanding 300,000 experts, topping Guidepoint Global's 150,000 experts[59] and MEDACorp's 30,000.[60] In contrast, Primary Global Research merits notoriety not only because it, with Galleon Group founder Raj Rajaratnam, violated insider trading

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[54] *See* GROYSBERG, *supra* note 20, at 2 (reporting revenues over $250 million in 2008, 2009, and 2010); Laurie P. Cohen, *Seeking an Edge, Big Investors Turn to Network of Informants*, WALL ST. J. (Nov. 27, 2006), *available at* http://online.wsj.com/article/SB116459881353833275-search.html?KEYWORDS=gerson+lehrman&COLLECTION=wsjie/6month table (showing a combined industry revenue estimate of $299 million).

[55] GROYSBERG, *supra* note 20, at 2 (citations omitted) ("These firms generated an estimated $400 million in revenues in 2010, up from $364 million in 2009, but down from the industry peak of $433 million in 2008.").

[56] *Id*. ("According to a research report by Integrity Research Associates, the number of expert network firms, which Integrity defined as a firm that "actively puts investors in direct contact with experts," increased from only four in 2007 to 38 in 2009.").

[57] *See* discussion *infra* text accompanying notes 58–62.

[58] Cohen, *supra* note 54 (showing GLG capturing $200 million of the $299 million industry).

[59] *About Us*, GUIDEPOINT GLOBAL, http://www.guidepointglobal.com/about.html (last visited Mar. 25, 2013) ("Our Company is built on a unique foundation of a powerful primary research consulting network, sector focused research staff and rigorous compliance, that is at the heart of all that we do: . . . [o]ver 150,000 industry and subject matter experts globally, strategically recruited by sector-focused research project managers . . . .").

[60] *Leerink Swann MEDACorp*, LEERINK SWANN, http://www. leerink.com/medacorp.aspx (last visited Mar. 25, 2013) ("Over the past 15 years, MEDACorp has amassed more than 30,000 healthcare professionals . . . .").

rules[61] but also because its former employees have been convicted on insider trading charges.[62]

Despite these convictions, expert networks are legal.[63] The SEC is explicit: "it is legal to obtain expert advice and analysis through expert networking."[64] Nevertheless, because expert networks trade in nonpublic information, if the information is "also material and is obtained through a breach of a duty," the expert networks could be violating insider trading law.[65] Because of this inherent conflict arising from the business of trading information, both the SEC and the Department of Justice ("DOJ") are active in investigating expert networks for violations of insider trading.[66] In 2011, the very first expert network case brought to trial successfully concluded with the conviction of the former Primary Global Research consultant.[67]

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[61] Jones, *supra* note 19 ("Perhaps the name that's turned up most frequently: California-based Primary Global Research LLC, which played a key role in the insider-trading case involving former Galleon Group head Raj Rajaratnam.").

[62] *Id*. ("[S]everal former Primary Global employees have been convicted on insider-trading-related charges.").

[63] *See* discussion *infra* text and accompanying note 64.

[64] 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 (last visited Mar. 25, 2013) ("[I]t is legal to obtain expert advice and analysis through expert networking arrangements . . . .").

[65] Bondi & Lofchie, *supra* note 43, at 177–78 ("When such nonpublic information is also material and is obtained through a breach of a duty to the source, the information could trigger a violation of insider trading law.").

[66] *See* Patrick Craine & Lashon Kell, *Prosecuting Insider Trading: Recent Developments and Novel Approaches*, 59 ADVOC. 45, 48 (2012) ("Both the SEC and the DOJ have been vocal about their focus on investigating expert networks. . . . Both the SEC and DOJ pursued insider trading charges against employees of the 'expert network' firm, Primary Global Research LLC ("PGR"), and certain consultants.").

[67] *See id*. ("Finally, in United States v. Jiau, the DOJ brought the first expert network case to trial. . . . The jury convicted Jiau.").

E. Expert Networks Must Guard Against Insider Trading

Expert network firms, heeding the example of Primary Global Research, must guard against insider trading.[68] Insider trading is "trading a security on the basis of material nonpublic information, where the trader has breached a duty of trust or confidence owed to either an issuer, the issuer's shareholders, or the source of the information, and where the trader is aware of the breach."[69] When enforcement agencies like the SEC or the DOJ investigate an insider trading case, the three primary issues are (1) whether the information was nonpublic; (2) whether the information was material; and (3) whether there was a breach of duty.[70] Expert networks must guard against all three elements in every transaction between client and consultant to avoid insider trading and related allegations.[71]

First, information is nonpublic unless the information was "disclosed in a manner sufficient to insure its availability to the investing public."[72] Public disclosures include dissemination via

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[68] *See* discussion *supra* text accompanying notes 61–62.

[69] Bondi & Lofchie, *supra* note 43, at 153 (citing to 17 C.F.R. § 240.10b5-1,-2) ("In general terms, insider trading laws prohibit trading a security on the basis of material nonpublic information, where the trader has breached a duty of trust or confidence owed to either an issuer, the issuer's shareholders, or the source of the information, and where the trader is aware of the breach."). This definition refers to the illegal version of insider trading. The legal version of insider trading involves "corporate insiders—officers, directors, and employees—buy and sell stock in their own companies." *Insider Trading*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/insider.htm (last visited Mar. 25, 2013) ("[T]he term ["insider trading"] actually includes both legal and illegal conduct. The legal version is when corporate insiders—officers, directors, and employees—buy and sell stock in their own companies.").

[70] *See* discussion *infra* text accompanying notes 72–89.

[71] *See* discussion *infra* text accompanying notes 72–76.

[72] Bondi & Lofchie, *supra* note 43, at 171 (internal quotation marks omitted) (citing to SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 854 (2d Cir. 1968) (en banc)) ("Under the first theory, information has reached the public realm when it has been disclosed "in a manner sufficient to insure its availability to the investing public.'"). A second theory of when information is public requires "information to be fully impounded into the price of the particular stock." *Id*. (citing to United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993)). However, the SEC maintains the test of *Texas Gulf Sulfur Co*. *Id*. ("Although this second approach, inspired by the efficient market

"traditional means" such as corporate disclosures, press releases, and television programs as well as through "new forms" like blogs, social media platforms, and professional networking websites.[73] Since the fundamental value of expert networks is access to and transfer of nonpublic information,[74] expert network firms cannot realistically prohibit nonpublic information transfer.[75] Thus, expert network firms must ensure that the nonpublic information is not material and not obtained through a breach of duty.[76]

Second, information regarding an "undisclosed fact" is material when "there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision."[77] When information regards speculative events such as mergers, acquisitions, or bankruptcies, the materiality must pass an additional hurdle: a "balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in

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theory, seems more sophisticated in taking account of new forms of online media and communications, the SEC has clung to the first theory, arguing that information becomes public only by a 'public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group.'").

[73] *Id.* at 173-74 ("Information can reach the public domain through a variety of traditional means, including corporate disclosures, press releases, media interviews, analyst and investor conference calls, analyst reports, and television programs. In addition, new forms of electronic communication, such as online message boards, blogs, chatrooms, social media (e.g., Twitter, Facebook, MySpace, and Friendster), professional networking websites (e.g., LinkedIn, Plaxo, and Chamber), and specialized websites focused on leaked information (e.g., WikiLeaks), can place information in the public domain.").

[74] Bondi & Lofchie, *supra* note 43, at 177 ("Indeed, their raison d'être is to convey information that is not readily available to the public."). An expert would not be much of an expert if all she knew was only as much as the investing public.

[75] *See* discussion *supra* note 74 and accompanying text.

[76] *See* discussion *supra* text accompanying notes 72–75.

[77] Bondi & Lofchie, *supra* note 43, at 179 (internal quotation marks omitted) (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)) ("In the context of an undisclosed fact, the Supreme Court in TSC Industries, Inc. v. Northway, Inc. held that information is material if 'there is a substantial likelihood that a reasonable shareholder would consider it important' in making an investment decision.").

light of the totality of the company activity."[78] For expert networks, materiality is problematic.[79] The expert network firm, its investor client, and the outside expert consultant will insist that any consultation exclusively reviews non-material information; however, subjects and details in which a client would be interested inherently would have "a substantial likelihood that [the client] would consider it important."[80] Thus, it would seem that information exchanged through an expert network might always be material.[81] Defenses to insider trading charges on the materiality element often raise the "mosaic theory of investing," a legal practice where an investor "assembles multiple pieces of non-material information to reach a material conclusion . . . [about] the broader position of a particular company."[82] While the mosaic theory has been historically

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[78] *Id.* at 180 (citing Basic. Inc. v. Levinson, 485 U.S. 224, 238–39 (1988) (citing SEC v. Tex. Gas Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968))) ("In the context of contingent or speculative events such as mergers, acquisitions, and bankruptcies, the Supreme Court set forth an additional test for materiality. In Basic v. Levinson, the Court held that materiality depends upon 'balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"). To illustrate by example: a low probability upcoming merger would have a "significant impact on a small company" and is probably material. *Id*. ("Following Basic, an event with a relatively low probability, such as an upcoming merger, could have a significant impact on a small company and thus be deemed material."). But a low probability upcoming merger for a "major, diversified company" might be immaterial. *Id*. ("Conversely, information regarding a similar type of event could be ruled immaterial in the context of a major, diversified company.").

[79] *See* discussion *infra* text accompanying notes 80–83.

[80] Bondi & Lofchie, *supra* note 43, at 179 ("In the context of an undisclosed fact, the Supreme Court in TSC Industries, Inc. v. Northway, Inc. held that information is material if 'there is a substantial likelihood that a reasonable shareholder would consider it important' in making an investment decision.").

[81] *See* discussion *supra* text accompanying note 80.

[82] Bondi & Lofchie, *supra* note 43, at 154–55 ("In general, an investor that assembles multiple pieces of non-material information to reach a material conclusion has not violated insider trading laws, regardless of whether the information obtained was nonpublic. . . . This practice is commonly referred to as the 'mosaic' theory of investing and it can serve as the basis of a defense to insider trading charges . . . .").

defensible, regulators and investors now wonder if it is actually insider trading.[83]

Whether an investor breaches a duty turns on the particular theory of insider trading that the government asserts.[84] Of the three theories of insider trading—the classical, the tipper-tippee, and the misappropriation theories—[85]expert networks must be most concerned with the tipper-tippee theory.[86] Under this theory, liability exists "when (1) the tipper has breached his fiduciary duty to . . . shareholders by disclosing . . . [material nonpublic] information to the tippee," (2) "the tippee knows or should know that there has been a breach," (3) "the tippee uses the information in connection with a securities transaction, and (4) the tipper receives some personal benefit in return."[87] Proof under the tipper-tippee theory in the case of expert networks must show that (1) the expert consultant acted as a tipper, disclosing the material nonpublic information in a breach of

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[83] Andrew Ross Sorkin, *Just Tidbits, or Material Facts for Insider Trading?*, N.Y. TIMES (Nov. 29, 2010, 08:56 PM), http://dealbook.nytimes.com/2010/11/29/just-tidbits-or-material-facts-for-insider-trading/ ("Amid a wide-ranging investigation by the Securities and Exchange Commission and federal prosecutors into hedge funds and the 'expert networks' that supplied them information, some investors may be asking themselves if their 'mosaics' may soon be considered 'insider trading.'").

[84] Bondi & Lofchie, *supra* note 43, at 185 ("Whether an individual has violated a duty is dependent on the particular theory of insider trading that the government is asserting.").

[85] *Id*. at 156–57 ("Based upon these provisions, the Supreme Court has long recognized three general theories of insider trading liability, commonly referred to as: (1) the 'classical' theory, (2) the 'tipper-tippee' theory, and (3) the 'misappropriation' theory.").

[86] *See* Stephen Madsen, *How to Avoid the Pitfalls of Expert Networking*, LAW360 (Apr. 20, 2011), ("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.").

[87] Bondi & Lofchie, *supra* note 43, at 157 (internal quotation marks omitted) (citing Dirks v. SEC, 463 U.S. 646, 647 (1983)) ("The 'tipper-tippee' theory imposes liability when (1) the tipper has breached his fiduciary duty to the shareholders by disclosing the [material nonpublic] information to the tippee, (2) the tippee knows or should know that there has been a breach, (3) the tippee uses the information in connection with a securities transaction, and (4) the tipper receives some personal benefit in return.").

fiduciary duty, and received personal benefit and (2) the client investor acted as a tippee, who, knowledgeable of the breach, used the information in connection with a securities transaction.[88] Difficulties in prosecution lie in proving the duty and the breach of duty rather than the personal benefit element or the use of information in connection with a securities transaction.[89] Thus, expert networks must guard against all three elements of insider trading, namely using nonpublic information, using material information, or causing a connected breach of duty, in every transaction between client and consultant to avoid insider trading and insider trading allegations.[90]

F. Strong Compliance Programs and Well-Written Contracts Protect Expert Networks Against Insider Trading and Regulatory Investigations

Given the risks of three independent ways to violate insider trading laws, expert network firms, investor clients, and expert consultants must guard against it.[91] Each party may be found liable.[92] For example, in *SEC v. CR Intrinsic*, the SEC charged the investor client CR Intrinsic, its portfolio manager Martoma, and the expert consultant Sidney Gilman with insider trading.[93] Contrary to expectation, the SEC and the DOJ are not pursuing GLG, the expert network firm that enabled the insider trading and previously examined.[94] The decision to forgo action against GLG may be attributed to GLG's purportedly strong compliance program and its well-written contracts.[95]

These strong compliance programs offer double protection by both preventing insider trading and by dissuading enforcement

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[88] *See* Madsen, *supra* note 86 (reviewing the elements of tippee liability).
[89] *See generally* discussion *supra* text accompanying notes 84–88.
[90] *See* discussion *supra* text accompanying notes 72–89.
[91] *See* discussion *supra* text accompanying notes 72–89.
[92] *See* discussion *supra* text accompanying notes 72–89.
[93] *See SEC Complaint*, *supra* note 2, at 1 (naming CR Intrinsic, Martoma, and Gilman as defendants).
[94] *Id*. The SEC not only did not name GLG as a defendant, but also, the SEC did not name GLG as one of the "relevant entities" which included Elan, Wyeth, "Investment Adviser A," and "Portfolio Manager A." *Id*. at 4–5.
[95] *See* discussion *infra* text accompanying notes 96–104.

agencies from prosecuting insider trading investigations.[96] Robust compliance includes screening for prior disciplinary and regulatory actions in background checks, documentation of all interactions with experts, and explicit agreement to not convey material nonpublic information.[97] Additionally, properly effective compliance programs signal to regulators "that [the] firm has taken appropriate steps to guard against potential wrongdoing."[98]

Even if the compliance programs fail to prevent insider trading, the compliance programs, combined with well-written contracts with expert consultants, can effectively isolate an expert network firm from potential liability.[99] For example, GLG Terms and Conditions ward off allegations of actual agency by requiring each Council Member ("CM") to submit that she is "a non-agent independent contractor of GLG."[100] The Terms and Conditions also require that CMs must not

> [d]isclose material, nonpublic information about a public company; [d]isclose confidential information about, or belonging to, past or present employers; [d]isclose information that [CMs] have a duty or have agreed to keep confidential (e.g., by agreement, fiduciary duty, etc.); or (4) [d]isclose information

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96 *See* discussion *infra* text accompanying notes 97–104.

97 Bondi & Lofchie, *supra* note 43, at 195–96 ("Any potential 'red flags' that appear in the background check, such as disciplinary and regulatory actions, could be reviewed by a member of the firm's compliance or legal team before any discussions with the expert occur. . . . . Firms are urged to document all discussions or meetings with experts. . . . . Firms also may consider requiring that all discussions with an expert begin with a script in which the expert assents to the following points: that the expert understands that the client does not wish to receive material nonpublic information . . . ."). Bondi & Lofchie suggest these tactics for companies or financial service firms using expert network firms; however, the tactics are just as applicable to expert network firms.

98 *Id*. at 178 ("If properly executed, compliance programs can demonstrate to authorities that a firm has taken appropriate steps to guard against potential wrongdoing, such as the potential receipt of material non-public information from a "tipper," thereby showing that further investigation is unlikely to reveal violations.").

99 *See* discussion *infra* text accompanying notes 100–103.

100 *GLG Terms & Conditions*, *supra* note 30 ("As a Council Member, you acknowledge that you are a non-agent independent contractor of GLG.").

> that [CMs] obtained from any person who expects [CMs] to keep . . . confidential or that [CMs] believe to be confidential.[101]

These contractual prohibitions stem directly from the specific expert network insider trading concerns discussed in Part E.[102] Furthermore, the Terms and Conditions explicitly indemnify GLG, having CMs "release GLG, and any and all persons acting under its permission or authority from any claim, liability or action in law."[103] Strong compliance programs and well-written contracts between an expert network firm and its expert consultants both prevent insider trading and dissuade enforcement action against expert network firms.[104]

G. Lack of Bright-Line Rules, Market Adjustments, and Spreading Risk and Liability of Insider Trading Urges Strict Adherence to Robust Compliance Programs

Even with compliance programs and well-written contracts, expert network firms and related entities still face the lack of bright-line rules, free market adjustments, and the risk and liability distribution associated with insider trading.[105] When SEC Division of Enforcement Director Robert Zhuzami announced the SEC's charge

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[101] *Id*. ("While there may be many limitations on the scope of your participation and the subjects you may discuss, you specifically agree that at a minimum you shall not do any of the following at any time as part of your participation in the GLG Councils: Disclose material, nonpublic information about a public company; Disclose confidential information about, or belonging to, past or present employers; Disclose information that you have a duty or have agreed to keep confidential (e.g., by agreement, fiduciary duty, etc.); Disclose information that you obtained from any person who expects you to keep it confidential or that you believe to be confidential . . . .").

[102] *See* discussion *supra* Part E.

[103] *GLG Terms & Conditions*, *supra* note 30 ("You additionally release GLG, and any and all persons acting under its permission or authority from any claim, liability or action in law, including any claims for defamation, copyright infringement, or invasion of privacy, arising in connection with your Content.").

[104] *See* discussion *supra* text accompanying notes 96–103.

[105] *See* discussion *infra* text accompanying notes 106–127.

against CR Intrinsic, Martoma, and Gilman for "the most lucrative insider trading scheme ever charged,"[106] he made the lesson simple: "[D]o right and not wrong, and play by the rules."[107] Similarly, former SEC Chairman Mary Schapiro declared, "[t]here is a line—I think it is a pretty bright line—when you cross over into insider trading."[108]

The SEC thinks the rules are clear and that the line between illegal insider trading and permissive due diligence is a bright line.[109] But it is not.[110] First, regulators and investors now question the mosaic theory of investing, especially after Raj Rajaratnam's demise.[111] Next, the three primary hurdles required to prove insider trading—(1) proving the information was nonpublic, (2) proving the information was material, and (3) proving duty and a subsequent breach of duty—when taken together and in the face of strong

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[106] Peter Lattman, *Insider Inquiry Inching Closer to a Billionaire*, N.Y. TIMES, Nov. 21, 2012, at A1 (quoting United States attorney for the Southern District of New York Preet Bharara who brought charges against Mathew Martoma in the Federal District Court in Manhattan).

[107] Robert Khuzami, Dir. of the SEC's Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks During News Conference Announcing Charges in a $276 Million Insider Trading Scheme (Nov. 20, 2012), *available at* http://www.sec.gov/news/speech/2012/spch112012rk.htm ("But I want to take a moment and speak not to today's insider traders, but to tomorrow's—those persons, Wall Street professionals or increasingly not, who will wake up tomorrow morning tempted by the mirage of success and false profits. When they read the headlines about today's case that all of you will write, my message to them is to let that be a moment of conscience and calculation. It can be a moment of conscience when they read the headlines and recall the most basic advice that they learned as children, the same advice they teach their own children—do right and not wrong, and play by the rules.").

[108] Jones, *supra* note 19 ("'There is a line—I think it is a pretty bright line—when you cross over into insider trading,' Ms. Schapiro said. 'There is nothing wrong with doing tremendous due diligence' when it comes to stock research.").

[109] *See* discussion *supra* text accompanying notes 106–108.

[110] *See* discussion *supra* Parts E, F.

[111] Sorkin, *supra* note 83 ("Amid a wide-ranging investigation by the Securities and Exchange Commission and federal prosecutors into hedge funds and the 'expert networks' that supplied them information, some investors may be asking themselves if their 'mosaics' may soon be considered 'insider trading.'").

compliance programs, provide a high burden for prosecutors.[112] These high hurdles tempt expert network consultants and investor clients to toe the line that separates aggressive but permissible due diligence and illegal insider trading.[113]

Expert networks operate and profit in the gray space very near this line.[114] But perhaps the market adjusts on its own.[115] Industry revenue in the expert network space peaked five years ago in 2008.[116] Various asset managers, private equity firms, and hedge funds have been terminating use of expert network firms.[117]

The risk and liability not only stings expert network firms, but also spreads through the network to poison expert consultants and investor clients.[118] A former expert consultant is currently serving a four-year prison sentence[119] while another risks thirty years in prison.[120] Sidney Gilman, the expert consultant in *SEC v. CR Intrinsic*, lost his professorship and paid $234,000 to settle the case

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112 *See* discussion *supra* Parts E, F.

113 *See generally* discussion *supra* Part A.

114 *See* discussion *supra* Parts C, D.

115 *See* discussion *infra* text accompanying notes 116–125.

116 *See* discussion *supra* note 55 and accompanying text.

117 GROYSBERG, *supra* note 20, at 8 ("In reaction to the negative press, a number of asset managers, including Balyasny Asset Management, Loch Capital Management and Och-Ziff Capital Management, were quoted as saying they had suspended the use of expert network firms pending further review. One employee of a private equity firm spoke anonymously, 'We've completely stopped using them, indefinitely, on the advice of our legal counsel.' Other firms, such as the $10 billion hedge fund Millennium Partners, while they did not make any public statements, were also rumored to have suspended the use of expert network firms.").

118 *See* discussion *infra* text accompanying notes 119–125.

119 Walter Pavlo, *Winifred Jiau Gets 4 Years in Prison, and What a Journey*, FORBES (Sept. 21, 2011, 06:48 PM), http://www.forbes.com/sites/walterpavlo/2011/09/21/winifred-jiau-gets-4-years-in-prison-and-what-a-journey/ ("Of all of the people sentenced thus far in U.S. Attorney Preet Bharara's mission to clean up insider-trading on Wall Street, Winifred 'Winnie' Jiau has become the poster child of the person who was in the wrong place at the wrong time. Today, Jiau was sentenced to 48 months in prison, getting credit for time already served . . . [S]he has been imprisoned since her arrest in December 2010 in maximum security prisons.").

120 Craine & Kell, *supra* note 66, at 48 ("Shimoon pleaded guilty to two counts of conspiracy to commit securities fraud and wire fraud and one count of securities fraud. He faces up to thirty years in prison.").

even after promising to assist authorities.[121] And the poison goes even further.[122] SAC Capital Advisors and its founder Steven A. Cohen, unnamed but implicated in *SEC v. CR Intrinsic*, have billions of dollars on the line.[123] Clients of the hedge fund "have asked to withdraw $1.7 billion . . . as the government's insider trading investigation intensifies."[124] This withdrawal amounts to more than a quarter of the $6 billion that the fund manages for clients.[125]

For expert networks to continue, all parties involved, from expert network firm to client to consultant, must be aware of and guard against insider trading concerns.[126] Investigations by the regulators like the SEC and DOJ and the corresponding echo by Wall Street call for strict adherence to robust compliance programs in order prevent insider trading and to fight against the reputational inertia tying together expert networks and insider trading.[127]

Daniel H. Jeng[128]

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[121] Adam Rubenfire & Austen Hufford, *Embroiled in Scandal, Neurology Professor Retires*, MICH. DAILY (Nov. 28, 2012), http://www.michigandaily.com/news/11medical-school-professor-retires-amid-insider-trading-scandal28 ("Gilman has signed a non-prosecution agreement with the SEC, meaning he will not be criminally charged because he has agreed to testify and cooperate with further investigations. He will pay $234,000 in settling the suit.").

[122] *See* discussion *infra* text accompanying notes 123–125.

[123] Peter Lattman, *SAC Clients Said to Seek $1.7 Billion in Refunds*, N.Y. TIMES, Feb. 19, 2013, at B1 ("Clients of SAC Capital Advisors have asked to withdraw $1.7 billion from the giant hedge fund as the government's insider trading investigation intensifies, according to people briefed on the matter.").

[124] *Id*. ("Clients of SAC Capital Advisors have asked to withdraw $1.7 billion from the giant hedge fund as the government's insider trading investigation intensifies, according to people briefed on the matter.").

[125] *Id*. ("That amount represents slightly more than a quarter of the $6 billion that the fund manages for clients, and underscores the reputational damage to SAC from a spate of criminal cases tied to former employees of the firm.").

[126] *See* discussion *supra* Parts E, F.

[127] *See* discussion *supra* text accompanying notes 106–126.

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