Take It from an Expert?
A Look Inside the Expert Network Industry

The adage “take it from an expert” has long implied a seal of knowing approval. And for over a decade, the expert network consulting industry has carved out a lucrative niche trading on this tacit claim.

As long as “restricted” corporate information is not shared, the information provided by consultants working for expert networks is sound from a regulatory perspective. However, insider trading allegations now hover over the industry and challenge its future.

In some respects, concerns about insider trading in the expert network space were inevitable. Expert networks put portfolio managers, analysts, institutional investors and other investment managers in direct contact with subject experts who possess extensive knowledge of specific sectors, industries and/or companies.

Conceptually, the idea is similar to the use of medical testimony from doctors in court cases. Just as those who provide expert medical testimony are meant to offer valuable insights that inform verdicts, expert network consultants are intended to provide insight into complex information within certain industries and sectors, and thus help inform investment decisions.

Many financial market practitioners consider the expert networks a valid and useful part of the research industry. However, those individuals suspicious of the growing use of expert networks contend that expert network services actually offer little benefit to the market as a whole.

“Experts”, they argue, should be the equity analysts at investment firms themselves.

Critics contend that if expert networks are used to cover large, publically-traded companies, then there is little legitimate value because most relevant information should already be priced into the market. In this scenario, the most substantial well of corporate information left is “restricted” or inside information and using that information to inform investments is illegal.

Indispensable

During the past decade, expert network services have grown into a resource that many buy-side investors say that they cannot do without.
According to an Integrity Research Associates report on expert networks, roughly one-quarter of the investment industry’s independent research budget was spent on expert network services in 2009. This same report estimated the industry’s revenue to be at $360M.

Today, many expert networks do more than connect investors with experts who can help them arrive at better investment decisions. Over the years the expert network model has evolved and expanded to include services, such as customized surveys and polls and weekly teleconferences about trends. Proprietary data products that can be made available to an expert network’s entire clientele and trend-driven longitudinal surveys of experts are also offered by some networks.

When selecting an expert network, investment managers often examine the skill with which they are matched up with experts (on the basis of their specific request), the quality and usefulness of the information provided and the speed of the match process.

An expert network’s compliance capabilities and the cost of services are also key considerations.

Price competition among expert network firms has been intense in recent years as expert network firms, such as Guidepoint Global and Coleman Research, have vied to wrestle market share from the expert network industry leader, Gerson Lehrman Group (GLG).

In its 2009 report, Integrity Research Associates said that the effect of these price wars might take years to wear off. At the time of its report, Integrity predicted that it might take until 2013 before expert network industry revenues return to 2008 levels.

The difficult market conditions that defined 2008 had a limited effect on expert networks, partly because many buy-side clients opted to scale back their internal headcount and outsource more research.

Today, there are roughly three dozen expert network firms operating in the US.

The Biggest Risk

Compliance has long been a complicated matter for the expert network industry.

Experts at publically-traded companies have policies and procedures for their interaction with external individuals, and their clients, investment firms, have their own policies and procedures. Additionally, all parties must operate within the boundaries set by regulators, and all parties bear the risk associated with compliance failures.

For the expert network industry, being able to demonstrate adherence to compliance is an essential but an expensive endeavor.

Industry leader GLG attributed the market share that it lost in 2006 to its decision to spend that year focusing on instituting more rigorous compliance standards. However, they also say they were awarded several sole-source contracts as a direct result.

To enhance compliance standards, some expert networks have taken steps to improve their team training programs, implemented new or tightened existing systems aimed at detecting conflicts of interest and/or created more detailed terms and condition contracts for the experts that they work with.

Other tactics, such as barring experts from consulting about the company that they work for and limiting the annual number of phone consultations between experts and clients, are also gaining traction.

Game Changer

Although possible insider trading within the expert network industry has been grabbing recent headlines, reports of abuse within the industry date back to 2005—just five years after Regulation Fair Disclosure (Reg FD) redefined the rules around corporate disclosure of material information.

Expert networks were around before Reg FD, but it was in the wake of this regulatory change that they really took flight.

Reg FD states that publically-traded companies must disclose material information to all investors at the same time. It was ushered in after individual and small investors raised concerns that they were not able to sit in on quarterly conference calls during which a company’s management would sometimes disclose results or
other market-moving information and/or answer analyst questions.

Initially, many large institutional investors actively opposed Reg FD. They said that the SEC’s proposal, which was meant to create a more even playing field, would, in fact, lead to less corporate disclosure and, thus, a less informed market.

After Reg FD was passed, expert networks became more widely-used because they enabled investment firms to obtain information not readily available to the public via conference calls and annual reports. Firms felt the added information gave them back the competitive edge they had prior.

There is little doubt that the current, federal investigation into insider trading in the expert network industry is negatively affecting the industry.

The nationwide probe that is now underway has already prompted some corporations to reconsider their policies about outside consulting work and review their methods of enforcing these policies. It has also led some hedge funds and investment managers to reassess or, in some cases, suspend use of expert network firms’ services.

Which Way Forward?

While some market participants say that existing insider trading regulation can be tweaked and applied to the expert network industry, others say new regulations, tailored to the activities in which expert networks engage in, are needed.

Whatever your view, further regulation of the industry is likely. The current federal investigation has already prompted:

- Corporations to reconsider their policies about outside consulting work and review their methods of enforcing these policies
- Investment Managers to reassess or, in some cases, suspend their use of expert network’s services
- Expert networks to begin tightening their compliance in anticipation of tighter regulations

Just as Reg FD altered how investment managers conduct research, the current insider-trading crackdown will likely change the way the expert networks—and the investment firms that work with them—do business.