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Insider Trading: From Fantasy Football to Federal Prison?

From the Experts

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"Santonio Holmes is out—four weeks with a strained hamstring. I heard Geno Smith will get the start, and the Jets will keep Kahlil Bell as their short yardage back. The official announcement isn't supposed to come until later in the week, after Wednesday's practice."

Every year, from September through January, this type of water-cooler conversation can be overheard, as football fans discuss the weekend's games and the latest gossip about their favorite players.

Such conversation seems harmless. But could it be a federal crime?

That possibility doesn't seem so far-fetched now that Fantex Holdings, a Silicon Valley start-up, has launched an exchange where investors trade shares of athletes' "brands." It works like this: Fantex makes a one-time, lump-sum payment to an athlete in exchange for a cut of the athlete's future earnings, including endorsements and other revenue from the athlete's celebrity status. Two athletes have signed with Fantex so far—Arian Foster of the Houston Texans will receive $10 million in exchange for a 20 percent stake in his brand, while San Francisco 49ers tight end Vernon Davis will get $4 million in exchange for a 10 percent share.

To finance the lump-sum payout, Fantex issues a "tracking stock" linked to the revenue stream of a particular athlete. For example, the IPO for the Arian Foster tracking stock will offer 1,055,000 shares at $10 each, generating $10,550,000. (After paying Foster his $10 million, the remaining $550,000 covers expenses related to the IPO.) Owners of this stock can then trade shares on a special exchange that Fantex hosts. In theory, the value of the tracking stock reflects the value of Foster's brand.

Securitizing sports—an industry already replete with gossip, hype and speculation—raises interesting insider-trading implications, particularly in light of recent enforcement efforts targeting insider trading beyond the "typical" Wall Street cases. Fantex provides a thought-provoking reminder that as financial markets evolve alongside changes in the ways in which investors obtain, process and use information, so does the risk of liability under insider trading law.

Insider Trading: The Basics

The basic prohibition on insider trading, which is derived from federal securities laws, is fairly straightforward: It is illegal to buy or sell a security on the basis of inside information—i.e., "material nonpublic information"—in breach of a duty of trust or confidence.

What constitutes material nonpublic information, however, is not always clear. "Material" information involves anything a reasonable investor would want to know when deciding to buy or sell a security. And information is "nonpublic" if it has not been effectively disseminated to the investing public. While these concepts are easy to define in the abstract, they can be difficult to apply in practice.

Moreover, trading on material nonpublic information is only illegal if it somehow "breaches a duty." This duty can arise from a traditional fiduciary relationship such as an attorney-client or employer-employee relationship. But it can also arise from a fiduciary-like relationship such as a business or family relationship where there is an expectation to keep certain information confidential or to not use that information for personal gain. However, there is no hard-and-fast rule as to what constitutes a relationship sufficient to trigger liability. Thus, whether a violation has occurred—that is, whether information is material and nonpublic, and the requisite duty has been breached—is highly dependent upon the facts and circumstances of each individual case.

The Next Generation Of Insider Trading Cases

Traditionally, insider trading cases have been based on the use of inside information obtained through corporate channels (think of Gordon Gekko from the movie Wall Street, trading on advance news of a hostile takeover). But that may no longer be the case. The nature of insider trading liability is continually evolving, as illustrated by recent enforcement investigations into the use of inside information obtained through government channels, so-called "political intelligence."

Political intelligence firms, typically comprised of lobbyists and former government officials, gather information and provide insight about regulatory developments, legislative initiatives and government policy. This information can potentially affect the prospects and profitability of individual companies and entire industries. Thus, it is not surprising that the use of political intelligence has become increasingly common among sophisticated investors.

Recent enforcement activity, however, has highlighted the risk that such intelligence may constitute prohibited inside information under insider trading law.

Indeed, earlier this year, the Securities and Exchange Commission launched an investigation into whether news of an important government announcement regarding reimbursement rates for Medicare participants—which caused a run-up in stocks of major health care companies—was improperly leaked by a government insider to a political intelligence consultant who, in turn, sold the information to investors who traded on it. While this investigation has not resulted in any enforcement action thus far, it illustrates how the traditional insider trading case has evolved, as investors turn to new sources of information in developing an investment idea or strategy.

Is Insider Trading For Sports Fans Next?

With the Fantex exchange up and running, could "sports intelligence" lead to the next evolutionary leap in insider trading enforcement? Sports analysis is big business. ESPN devotes countless hours to speculation about who will play, who is hurt and what strategy a team will deploy against an opponent. The book and movie Moneyball glorified the number-crunching approach that brought the Oakland Athletics to the playoffs in 2002 and 2003. And the prevalence of fantasy sports has only increased the demand for predictive analysis and the latest performance information.

The sports analysts producing this information are like the political intelligence consultants. They analyze numbers and stats, but also pick the minds of those with first-hand access to the locker room. What these sports analysts lacked, from the standpoint of insider trading law, Fantex now provides: a market where investors can trade on the basis of this information.

So where does that leave our watercooler tipper? If he or his co-worker heads back to his desk and buys $1,000 worth of Geno Smith shares on Fantex or sells all his Santonio Holmes holdings, has either engaged in insider trading? Like many things in the law, it depends. Smith's precipitous rise up the depth chart could be deemed material—it is information an investor would want to know before deciding whether to buy or sell Geno Smith shares. So is knowledge of Holmes's injury.

But is the information nonpublic? The answer depends on the source. If disclosed by the team's coach and published in the sports section of the New York Post, then probably not. But if our water cooler tipper is a sports reporter who overheard the tip while attending a closed practice at the special invitation of the team, then the information may be nonpublic and any trades on the Fantex exchange could trigger insider trading implications.

Perhaps a federal criminal probe targeting fantasy sports tips is a bit far-fetched. The larger lesson, however, is that even when the law governing insider trading does not change, the world in which it operates does. New markets arise, enforcement priorities change and information previously irrelevant to investing decisions takes on new importance. In order to assist employees and protect their businesses, buy- and sell-side firms—and all companies that deal with confidential information—need to stay abreast of these changes. They should also continually update their compliance policies and be vigilant in identifying and investigating possible signs of insider trading.

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