3-17-2012

# The Facebook Effect: Secondary Markets and Insider Trading in Today's Startup Environment

Stephen F. Diamond
*Santa Clara University School of Law*, sdiamond@scu.edu

**Stephen F. Diamond** joined the faculty of Santa Clara University School of Law in 1999 after positions as an associate at Latham & Watkins in New York and Wilson Sonsini Goodrich & Rosati in Palo Alto. While in practice, he represented a wide range of private and public companies, as well as investment banks, private equity funds, and venture capital funds. He is now an Associate Professor of Law and teaches business law, securities law, corporate finance, and international law. He has also taught at Cornell Law School and has been a visiting scholar at Harvard, Stanford, and the University of California. He is a graduate of Yale Law School, the University of London, and the University of California, Berkeley.

# The Facebook Effect: Secondary Markets and Insider Trading in Today's Startup Environment

Stephen F. Diamond

## INTRODUCTION

The ubiquitous social networking company Facebook made headlines in the spring of 2011 when it fired a widely respected senior manager because he violated the firm's insider trading policy. The dismissal was controversial not only because it surprised Silicon Valley and led many there to rush to the executive's defense, but also because it opened up a new chapter in a long-running policy debate about the nature of insider trading. The debate revealed a good deal of confusion about the legality and significance of insider transactions. One leading technology sector blog post even went so far as to quote unnamed sources stating—inaccurately—that insider trading was legal as long as it took place in the shares of a private company.

Beyond the issue of insider trading, however, the incident raised concerns about the emergence of new private capital markets such

*—continued on page 3*

as SharesPost and SecondMarket, where the securities of high-flying private companies such as Facebook, Yelp, and until recently, Zynga and Groupon can now be bought and sold with relative ease without the need to make the kinds of disclosure required of publicly traded companies. The trades that the Facebook executive made were allegedly carried out on such a private trading platform.

If the numbers reported in the wake of these trades can be believed, valuations of some private companies have reached stratospheric levels. Based on a recent trade in Facebook stock made through its service, SharesPost valued the social networking company at more than $75 billion, up from $17 billion in the spring of 2010. These kinds of numbers drive up the demand for shares in private companies. Because corporate insiders are one of the few sources of supply of such shares, skyrocketing valuations may tempt insiders to engage in trades with investors outside the company. The temptation to trade may be exacerbated when, as in the current economic crisis, startups have long delayed expected public offerings of their stock. Not all private trades by insiders are illegal, of course, but the Facebook incident highlights why it is important for lawyers engaged in representing startup companies or investors in such companies to consider carefully the impact of federal and state securities laws on insider transactions.

## BUSINESS LAWYERS ARE "SECURITIES LAWYERS"

Many law students avoid taking securities law in law school, yet it becomes clear in practice that almost any lawyer advising a business will encounter securities law issues. Thus, it is helpful to recall that the Securities and Exchange Commission (SEC) paints with a broad brush the definition of who is or is not practicing securities law. Although the SEC imposes no registration requirement or other formal oversight of attorneys, the Sarbanes Oxley Act of 2002 (SOX) (15 USC §§7201–7266) mandated that the SEC establish "minimum standards of professional conduct for lawyers appearing and practicing" before it. See SOX §307 (15 USC §7245); 17 CFR part 205; Securities Act Release No. 33–8185 (Jan 29, 2003); Securities Exchange Act Release No. 34–47276 (Jan 29, 2003).

Given the broad definition of "appearing and practicing" long in place in the SEC's rules of practice, on which the new rule implementing this SOX provision is based (see 17 CFR §205.2(a)), a lawyer who provides what seems to be the simplest form of advice to a new business entity may, in fact, be practicing securities law. The definition includes the following as a form of "appearing and practicing" before the SEC (17 CFR §205.2(a)(1)(iv)):

> (iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission.

Even at the earliest stage of the incorporation of a business, decisions need to be made about the basic capital structure of the new entity. How much and what classes of stock will be authorized and issued? On what terms and conditions will they be issued? At what price per share will they be valued? To whom will the securities be issued? And, of course, will it be necessary to register the issuance of these securities with the SEC or qualify them with the California Department of Corporations? Or is there an exemption from registration and qualification available? See generally Securities Act of 1933 (1933 Act), as amended (15 USC §§77a–77aa); California Corporate Securities Law of 1968 (Corp C §§25000–25707). The last of these questions falls squarely under 17 CFR §205.2(a)(1)(iv), because a lawyer representing a newly formed corporation must help the founders decide whether they need to make a filing with the SEC in connection with the issuance of the company's securities.

The potential penalties for violating state and federal securities laws are severe. Willful violations of the California securities law are punishable by a fine of up to $1 million or imprisonment for up to 1 year, or both. See Corp C §25540. Willful violations of the 1933 Act are punishable by a fine of up to $10,000 or imprisonment up to 5 years, or both. See 15 USC §77x. Although criminal convictions under these statutes are relatively rare, prosecutions for charges under insider trading laws are increasing in frequency. Most visibly in 2011, hedge fund billionaire Raj Rajaratnam was convicted of 14 counts of conspiracy and securities fraud and sentenced to 11 years in federal prison in connection with a widespread insider trading operation that he masterminded. Thirteen other figures involved in the Rajaratnam scandal have received, on average, a sentence of 3 years in prison each.

## "FOLLOW THE MONEY"

The clearest way to understand the potential effect of the securities laws on a startup company is to track the creation, distribution, and resale of securities issued by the company. There are numerous issues related to both securities and corporate law that will emerge in the startup company process, most of which are beyond the scope of this article. See generally Financing and Protecting California Businesses (Cal CEB 2006). However, the process can be tracked to better understand the impact of both the insider trading laws and the issues triggered by the emergence of new trading platforms such as SharesPost (https://www.sharespost.com) and SecondMarket (https://www.secondmarket.com).

Once a startup company is incorporated, it typically issues shares of common stock to founders and early-stage employees. Later, as the firm expands, it may issue preferred stock to angel investors or venture capitalists. The fundamental question that must be asked when a company contemplates an issuance of securities such as common or preferred stock is whether the issuance will require registration with the SEC or qualification by the California Department of Corporations. If registration and qualification are required, the company will need to undertake the expensive and time-consuming preparation of an information package that must be reviewed and approved by regulators and then given to potential investors.

The central principle animating the registration requirement is whether the individuals receiving or purchasing the securities can "fend for themselves," *i.e.*, whether they have sufficient information and sophistication to decide whether the investment decision they are being asked by the issuer to make is a reasonable one. See *SEC v Ralston Purina Co*. (1953) 346 US 119, 125, 97 L Ed 1494, 1499, 73 S Ct 981. If they can fend for themselves, then the transaction in those securities will be exempt from registration. Because this standard can be challenging to meet, the SEC has, over the years, used its rule-making authority to establish safe harbors from registration that allow a transaction to proceed with certainty that registration is not required. If an issuer or seller of a security is not confident that the sale will be exempt or that it meets the strict requirements of a safe harbor, then the transaction must be registered with the SEC and likely also qualified by the California Department of Corporations.

The California securities law is a so-called merit statute that applies a "fair, just, and equitable" standard to proposed offers and sales of securities in California. See Corp C §25140(a). Nonetheless, California law also offers a set of exemptions from its qualification requirements. See Corp C §§25102, 25102.1, 25102.5, 25103–25104. In some instances, federal law preempts the California requirement to qualify the offer and sale of securities under California law. See 15 USC §77r(b).

The legal framework described above implements what one might call the "prime directive" of securities law, namely that the offer and sale of any security must be registered (with the SEC) or qualified (by the California Department of Corporations) or both, unless an exemption is applicable. It should not come as a surprise that securities regulators take a very broad view of what constitutes a "security." Parsing out the elements of that definition is beyond the scope of this article, but almost any financial instrument issued by a startup to investors, such as preferred stock, common stock, or options to purchase either of those, will fall within that definition. See 15 USC §77b(a)(1); Corp C §25019.

Because the registration and qualification process is complex and time-consuming, both federal and state regulators make several safe harbors available to issuers that aid in the capital formation process. Thus, in most instances, it is fairly straightforward for issuers to issue securities to founders as well as early-stage employees and investors without incurring the cost of registration and qualification. See, *e.g.*, Rule 701 (17 CFR §230.701); Corp C §25102(f). As the company grows in size, it may wish to raise additional rounds of capital by engaging in similar private placements (*i.e.,* sales of securities made without registration or qualification) with investors, as well as to issue additional shares to employees or consultants. Each such issuance will require its own exemption or safe harbor.

Whether a company's securities are sold through a public offering or a private placement, the company is required in most cases to make available to potential purchasers a basic information package that helps level the playing field between the issuer and the purchaser. In a public offering (*i.e.,* a securities offering that is registered with the SEC), the package will include a prospectus that is reviewed and commented on by the SEC staff before actual sales of securities can take place. In a private placement, the issuer may provide potential investors with direct access to business records (*e.g.*, if the investors are senior officers of the issuer or early-stage angel investors) or prepare an offering memorandum or private placement memorandum that summarizes key business and financial information. It is in the issuer's interest to provide enough information to enable investors to make a reasonable decision regarding whether to enter into the transaction. The issuer's motivation to disclose material information is reinforced by the fact that the anti-fraud rules apply to all securities transactions, including transactions exempt from registration. See 15 USC 78j(b); 17 CFR §240.10b–5. See also Preliminary Notes, 17 CFR §230.701.

## THE SECONDARY MARKET FOR SECURITIES

The initial issuance of securities by a startup company is called a "distribution." It represents the first stage in creating a market for a company's securities. Once the securities are in the hands of the purchasers, they can be resold to other investors, thus providing liquidity for the original purchasers. In this secondary resale market, of course, no cash is generated for the issuer, only for the seller. Nonetheless, the seller must still comply with federal and state securities laws—the "prime directive" still applies. See 15 USC §77d(1)–(2); Corp C §25130. Thus, unless an exemption is available, a seller must provide sufficient information to a potential purchaser to enable him or her to make a reasonable decision regarding whether to buy the securities offered.

The purchaser normally must have the sophistication to analyze the information provided, thus meeting the "fend for themselves" standard discussed above. Unless the seller has negotiated with the original issuer (*e.g.*, in a registration rights agreement) to make the information available, the information requirement will be a difficult burden to meet. Moreover, even if an exemption from registration or qualification is available, the anti-fraud rules still apply.

There are readily available safe harbors that exempt most secondary sales of common stock in public corporations. See 15 USC §77d(1); Corp C §25111. A much greater challenge is presented to the shareholder of a private company such as a typical startup. Because very little information is available publicly about such a company, a shareholder may find his or her investment in the company "locked in," awaiting the registration of his or her shares through an initial public offering (IPO). The shareholder may have received sufficient information from the company to participate in the original share distribution. When he or she wishes to resell the shares, however, there may not be sufficient current information accessible to enable a prospective purchaser to make a reasonable decision regarding whether to purchase the shares in the resale (secondary) transaction.

Although this problem is faced by all private companies, it has been exacerbated by recent difficult macroeconomic conditions. Since the dot.com crash in 2000–2001, the length of time required for a startup to reach the IPO stage has grown significantly. The volatile market conditions that have emerged in the wake of the 2008 credit crisis have made the problem more severe. Although it was formerly possible for companies to conduct relatively small IPOs, that is no longer the case. For example, when Intel first went public, it raised only $7.2 million. Today, however, a company must often be large enough to raise at least $100 million for an investment bank to be willing to expend the effort needed for a successful transaction. In late 2011, there were more than 200 companies waiting to complete their IPOs because market volatility caused a number of prospective new public companies to withdraw from the registration process. In

September 2011, for the first time in 29 months, no IPOs whatsoever were conducted. As a result, an unknown number of investors in private companies have been left holding shares in companies that they would likely wish to sell but cannot because there is inadequate information available for prospective purchasers.

In light of these rough waters, new ways of providing liquidity to investors in early-stage companies have emerged. Trading platforms such as SharesPost and SecondMarket offer shareholders in private companies an opportunity to connect with willing purchasers of their shares. As SecondMarket states on its website (https://www.secondmarket.com/private-company?t=fl):

> SecondMarket specializes in designing and implementing fully-customized liquidity programs for private companies. Through these liquidity programs, private company shareholders can sell stock to company-approved investors in a company-controlled process.

Approximately $4.6 billion worth of securities of private companies traded hands in 2010, although most of those transactions were done between buyers and sellers directly without participation of the new trading platforms. For both sellers and buyers of securities on the new trading sites, the rules applicable to secondary securities transactions represent a complex legal minefield. Those rules ensure that the liquidity provided by secondary securities markets does not come at the cost of the core investor protections found in the federal and state securities laws.

***NOTE:*** So-called tertiary trades, in which an investor who bought from an individual who received shares in a distribution wishes to resell those shares to another third party investor, reportedly take place on the new trading platforms only rarely. Moreover, issuers do not engage in initial capital-raising offerings on these platforms. The platforms are thus distinguishable from stock exchanges such as the NASDAQ and NYSE.

The supply of securities for the new secondary trading platforms comes from several sources, each of which is seeking liquidity in startups such as Facebook that have not yet accessed the public markets or found another exit opportunity such as an acquisition. These sources include current and former employees whose stock options have vested, consultants or other service providers who may have earned shares as part of their short-term contributions to a business, and, finally, current investors in the startup. These security holders own so-called restricted securities, *i.e.*, shares issued without registration. To resell the securities to third parties, the security holder must find either a new exemption or a safe harbor from registration with the SEC and qualification with the California Department of Corporations. See 15 USC §77d(1)–(2); Corp C §25130.

The federal securities laws do not provide an explicit exemption for the resale of restricted securities. Instead, a doctrine has been crafted over time in a series of decisions by courts, the SEC, and market participants that allows for valid resales of restricted securities. This doctrine combined language found in one section of the 1933 Act (15 USC §77d(1)) with definitional information found in another (15 USC §77d(2)) to form a new informal rule known as “Rule 4(1½).” Later, the SEC issued Rules 144 (17 CFR §230.144) and 144A (17 CFR §230.144A) that created “safe harbors” for resales, thus providing buyers and sellers greater certainty that such transactions comply with the securities laws.

Ensuring that a resale complies with the securities laws is important for all three concerned parties—the seller, the buyer, and the issuer. The seller wants to avoid the costly and time-consuming obligation to draft a prospectus, which of course would require the issuer’s cooperation. A buyer wants to make sure that the transaction complies so that the buyer can look forward to a further resale later on. The issuer has an important residual concern: If a resale without registration is not handled properly, the SEC could find that the seller was, in fact, acting as a statutory “underwriter,” facilitating the distribution of the securities. See 15 USC §77b(a)(11). If so, the two-part sale—the initial distribution by the issuer to the seller and the later attempted resale by the seller to the buyer—would be collapsed into one transaction in which the issuer, as well as the seller-underwriter, would have joint responsibility for providing full prospectus-like disclosure to the buyer.

To ensure that buyers and sellers do not run afoul of these rules, the websites of the new trading firms explain that they screen potential investors so that they qualify for securities law exemptions or safe harbors. Thus, potential purchasers of the stock of private companies such as Facebook must qualify as "accredited investors" in order to participate in auctions for their securities. Accredited investors are generally thought to be able to fend for themselves when it comes to deciding whether to purchase shares in a private transaction. The federal securities laws define an "accredited investor" to include a range of financial or business institutions as well natural persons who meet certain qualifications. Thus,

> [a]ny natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000; [or] [a]ny natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year

qualifies as an accredited investor. See Rule 501(a)(5)–(6) (17 CFR §230.501(a)(5)–(6)).

***NOTE:*** The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub L 111–203, 124 Stat 13476) adjusted the definition of "accredited investor" to exclude the value of a person's primary residence in determining whether such person's individual net worth, or joint net worth with his or her spouse, exceeds $1 million. The Dodd-Frank Act also authorized the SEC to further adjust the definition of "accredited investor" as it applies to natural persons, and new SEC rules are pending. See Securities Act Release No. 33–9177 (Jan. 25, 2011).

In addition, the secondary market sites state that they only allow sellers who have held their shares for more than 1 year (the holding period required by the Rule 144 safe harbor; see 17 CFR §230.144) to resell their shares to other investors. The holding period helps to ensure that the original sale by the issuer (or its affiliate) to that seller was in fact an investment and not a distribution that would trigger a registration requirement. Finally, buyers on both SharesPost and SecondMarket must certify that they are qualified to participate in a private securities transaction.

## BACK TO INSIDER TRADING

The growing concern about insider trading in the purchase and sale of securities of private companies is founded on the laws governing securities transactions discussed above. The primary policy motivation underpinning the regulation of trading by insiders (whether buying or selling) is the potential information asymmetry between the insider and his or her counter-party in the transaction. Inevitably, the insider will have more information about the fundamentals of a business than an outsider. Federal and state securities laws are intended, in part, to "level the playing field" among buyers and sellers by mandating disclosure of material information about a security as well as prohibiting fraud in securities transactions.

The strongest view of insider trading regulation thus argues for an absolute "disclose or abstain" approach (see *U.S. v O'Hagan* (1997) 521 US 642, 661, 138 L Ed 2d 724, 746, 117 S Ct 2199) to achieve what the Second Circuit called "equal access" to material information among all market participants. See *SEC v Texas Gulf Sulphur Co*. (2d Cir 1968) 401 F2d 833, 851, cert denied (1969) 394 US 976, 22 L Ed 2d 756, 89 S Ct 1454. As discussed below, this approach is now limited by the requirement that the insider be in breach of a fiduciary obligation when he or she trades or provides information to others who trade. See *Chiarella v U.S.* (1980) 445 US 222, 63 L Ed 2d 348, 100 S Ct 1108. Nonetheless, this approach remains perhaps the most useful starting point for anyone in possession of material nonpublic information about a company's security, particularly employees or other potential insiders. In other words, if one party is in possession of material nonpublic information, it is important for that party to stop before trading and ask whether he or she has an obligation to "disclose or abstain." If so, that party must either provide the potential counter-party with the same material information that the first party has about the issuer whose shares the first party wishes to buy or sell, or else abstain entirely from entering into the transaction.

It is perfectly permissible, of course, for insiders to buy or sell the securities of the company for which they work if there is in fact a level playing field between the insider and the counter-party on the other side of the transaction. Even if there is not equal access to the same information, absent a fiduciary duty, an insider may also be able to trade. See, *e.g.*, *Dirks v SEC* (1983) 463 US 646, 77 L Ed 2d 911, 103 S Ct 3255. Thus, insider trading per se is not always illegal. But it does not matter if the company is public or private, as was suggested by some in the wake of the controversy over Facebook's dismissal of the executive who engaged in the purchase of Facebook shares on a secondary market platform. All securities transactions are subject to the insider trading laws and rules. More importantly, it will often be difficult for individual insiders—who are usually not securities lawyers—to determine when they are free to trade.

The prohibition on insider trading is based largely on the SEC's and the federal courts' application of the Securities Exchange Act of 1934 (1934 Act). The 1934 Act was passed in the wake of the stock market crash of 1929 during a period when it was widely believed that those "in the know" had benefited at the expense of the wider investing public through a variety of manipulative investment practices. A Congressional investigation was concerned about this issue, stating in an often-cited passage (S Rep No. 1455, 73d Cong 2d Sess 55 (1934)):

> Among the most vicious practices unearthed at the hearings . . . was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities.

Thus, §10(b) of the 1934 Act (15 USC §78j(b)) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> b. To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

***NOTE:*** The 1934 Act does contain one explicit prohibition on insider trading in §16(b). See 15 USC §78p(b). However, this is a limited remedy. In addition to directors and officers, only holders of more than 10 percent of the company's stock are subject to the §16(b) prohibition. There is no tipper-tippee liability (discussed below). Section 16(b) requires persons covered to return to the company any profits on purchases and sales that take place within 6 months of each other—the so-called "short swing" trading window. The broadly worded prohibition forces many trades to unwind that are not affected by inside information and can miss many that are so affected.

The SEC followed passage of the 1934 Act by promulgating Rule 10b–5 in 1942. Rule 10b–5 makes it unlawful "in connection with the purchase or sale of any security" (17 CFR §240.10b–5):

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Today, the insider trading prohibition is grounded on a narrower basis than the "level playing field" approach. In most instances, only where the insider owes a fiduciary duty to a less well informed counter-party would a purchase or sale to that counter-party be prohibited by law. The recognition of this duty pre-dates modern statutory securities law and was set forth as early as 1909 in the U.S. Supreme Court's opinion in *Strong v Repide* (1909) 213 US 419, 53 L Ed 853, 29 S Ct 521. In that case, the Court held that even though a director may not be under a fiduciary duty to disclose to a shareholder his or her knowledge affecting the value of the shares, that duty may exist in special cases. This declaration of a “special circumstances” test began to dissolve the older rule that corporate directors and officers were free to take advantage of their inside knowledge when dealing with corporate shareholders.

Over time, as the SEC and the courts began to interpret §10(b) and Rule 10b–5, the “special circumstances” approach broadened into the “classical theory” of insider trading. This theory covers both “permanent insiders” and those who become “temporary insiders” due to their access to material nonpublic information. The latter can include underwriters, lawyers, accountants, and consultants. See *U.S. v O’Hagan* (1997) 521 US 642, 652, 138 L Ed 2d 724, 741, 117 S Ct 2199. Neither type of insider can legally trade in the securities of the entity to whom they owe a fiduciary obligation while material nonpublic information remains undisclosed to the wider market. As the Supreme Court stated in *U.S. v O’Hagan* (citations omitted):

> Trading on such information qualifies as a “deceptive device” under § 10(b), . . . because “a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”. . . That relationship . . . “gives rise to a duty to disclose [or to abstain from trading] because of the ‘necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of . . . uninformed . . . stockholders.’”

In theory, the prohibition applies not only to actual insiders but also to persons who have been tipped off by those insiders. This is known as tipper-tippee liability. The extension of liability to tippers and tippees enabled securities regulators to close a potential loophole that might have allowed insiders to pass on information to a friendly third party to trade, thus avoiding direct liability. There are two elements that must be met to impose liability on the tipper: (1) He or she must have had a duty that was violated by the disclosure of insider information to the tippee, and (2) he or she must have received some form of personal benefit from the disclosure. See *Dirks v SEC* (1983) 463 US 646, 662, 77 L Ed 2d 911, 927, 103 S Ct 3255; *SEC v Yun* (11th Cir 2003) 327 F3d 1263, 1269. Tippee liability is predicated on the existence of the tipper’s duty as well as an awareness by the tippee that the duty was breached. See *Dirks v SEC*, 463 US at 661, 77 L Ed 2d at 926. The ongoing Galleon hedge fund scandal involves examples of both tipper and tippee liability and demonstrates the aggressive posture that the SEC takes towards this form of insider trading.

In *O’Hagan*, the Court broadened the scope of those covered by the insider trading prohibition with an endorsement of the “misappropriation theory” of insider trading. In that case, a lawyer working at a law firm representing the acquirer of a target company bought securities in the target before the takeover announcement. The Court held that the lawyer violated §10(b) and Rule 10b–5 “when he misappropriate[d] confidential information for securities trading purposes, in breach of a duty owed to the source of the information,” namely, his own law firm and its client, the acquiring company. *U.S. v O’Hagan,* 521 US at 652, 138 L Ed 2d at 741. Thus, the misappropriation theory compliments the classical theory of insider trading with a ban on trading by outsiders who trade on “confidential information that will affect the corporation’s security price when revealed, but who owe no fiduciary or other duty to that corporation’s shareholders.” 521 US at 653, 138 L Ed 2d at 741 (citation omitted).

Determining whether a duty of nondisclosure is present and providing the kind of information that truly levels the playing field can be difficult, particularly in the context of startup companies. As a consequence, a directive to “disclose or abstain” will usually result in an abstention from trading, absent exceptional circumstances. Only the startup firm itself can effectively make available to counter-parties the kind of information that would ensure that a sale or purchase does not run afoul of the prohibition on insider trading. It is therefore prudent for the company itself to set the terms under which its employees, consultants, and advisors can trade in its securities.

## INSIDER TRADING POLICIES

Some startup companies have established an insider trading policy (IT Policy). An IT Policy was previously thought necessary only for companies whose securities already trade or are about to begin trading on the public capital markets. With the emergence of significant opportunities for insiders to trade on secondary markets such as SharesPost and SecondMarket, however, it is now important for many startup companies to consider implementing such policies.

Prepared by outside securities counsel, an IT Policy should make clear to all company employees that trading by insiders may in certain circumstances be illegal under federal securities laws and carry severe penalties, including the possibility of imprisonment. Employees are more likely to take notice of their responsibilities under federal law when they are reminded that §32(a) of the Exchange Act (15 USC §78ff(a)) authorizes a judge to impose up to a $5 million fine and a 20-year prison sentence on those convicted of a §10(b) violation (15 USC §78j(b)). Section 32(a) also allows for criminal prosecutions against the issuing company if it is held responsible as a controlling person with respect to the illegal trading activity of its employees. Congress further raised the stakes for illegal insider trading with the passage of the Insider Trading Sanctions Act of 1984 (Pub L 98–376, 98 Stat 1264), which allows the SEC to secure treble damages against violators. See 15 USC §78u–1(a)(2)—(3). Finally, in 1988, Congress created a private right of action to allow those who traded contemporaneously with insiders to sue for damages. See the Insider Trading and Securities Fraud Enforcement Act (Pub L 100–704, 102 Stat 4677) (15 USC §78u–1).

***NOTE:*** Among the benefits of implementing an IT Policy are not only that it can lead to fewer instances of illegal trading by insiders but also that it can lead to mitigated criminal sentences under the Federal Sentencing Guidelines (see http://www.ussc.gov/Guidelines/2011_Guidelines/Manual_HTML/) and provide a defense for the company to imposition of controlling-person liability.

The IT Policy should establish a general principle that no employee should trade or cause someone else to trade the company's securities while in possession of material nonpublic information. The company may wish to condition the issuance of stock to employees on an agreement not to trade in those securities until an agreed-on exit, such as a public offering. Some companies have gone further, replacing traditional stock options with various forms of restricted stock units (RSUs) that cannot be sold and for which there is no secondary market. The recipients of RSUs do not receive actual stock in the issuing firm until a public offering is conducted. See *Zynga, Inc.* SEC No Action Letter (June 17, 2011).

The IT Policy itself should help educate rank and file employees, who are very likely not to have any familiarity with securities law, by providing clear examples of what material information means. Material information includes anything that might be considered reasonably important to the counter-party when making a decision concerning whether to engage in the purchase or sale of a security. This could include financial information such as revenues, operating margins, or net income; risk factors such as potential environmental liabilities; and background information on key executives. A leading U.S. Supreme Court opinion defined materiality as including anything that could significantly alter the "total mix" of information available about a particular company. See *TSC Indus., Inc. v Northway, Inc.* (1976) 426 US 438, 449, 48 L Ed 2d 757, 766, 96 S Ct 2126. Given the vagueness of this formulation, an IT Policy should err on the side of over-inclusiveness when it defines materiality. A good example of such a policy, although it was prepared for a public company, can be found on the website of the Practical Law Company at http://us.practicallaw.com/7–502–0160?q=insider%20trading%20policy.

## CONCLUSION

Although the founders of, and investors in, early-stage companies may chafe at the restrictions that an IT Policy places on liquidity, it is important that their counsel remind them of the far more catastrophic risk of facing liability for insider trading. In the intensely competitive environment of the startup world, reputational capital is likely the most precious asset that a young company owns. To risk that capital for short-term financial gain at the expense of outsiders makes no sense.