

NOTE

BIG BOY LETTERS: TRADING ON INSIDE INFORMATION

Edwin D. Eshmoili[†]

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INTRODUCTION

The Securities and Exchange Commission (SEC) long advocated the view that a party in possession of material, nonpublic information—regardless of the circumstances that lead to that knowledge—has a duty to disclose or abstain from trading.¹ Applied to corporate

[†] B.S., Binghamton University, 2006; J.D. Candidate, Cornell Law School, 2009. I am indebted to Osamu Watanabe for inspiring me to write on this topic. I am grateful to Joshua C. Teitelbaum and Jonah Fecteau for their insights and guidance. I appreciate my colleagues on the *Cornell Law Review* for all their assistance. Most of all, I thank my family and friends for their love and support.

¹ WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 659 (2d ed. 2007). This duty is premised on the belief that all market participants should have access to the same information, appealing to notions of fairness. See *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 852 (2d Cir. 1968) (en banc) (“[A]ll members of the investing public should be subject to identical market risks” and should “trad[e] on an equal footing” with each other.). The SEC successfully argued for this aptly labeled “equal access theory” in several landmark cases. See Craig W. Davis, Comment, *Misappropriators, Tippees, and the Intent-to-Benefit Rule: What We*

insiders, this duty is the essence of the classical theory of insider trading,² as sanctioned by the Supreme Court in *Chiarella v. United States*.³ An insider, then, must either disclose all material, nonpublic information pertaining to the underlying securities or abstain from trading altogether.⁴ Failure to disclose such information prior to trading exposes that insider to liability under SEC Rule 10b-5.⁵ But in a negotiated sale of securities between two sophisticated⁶ parties, can the parties agree *not* to disclose all material,⁷ nonpublic⁸ information and still transact?

Can Still Learn From Cady, Roberts, 35 SETON HALL L. REV. 263, 270 (2004) (“In *SEC v. Texas Gulf Sulphur Co.*, a paradigm insider trading case, the United States Court of Appeals for the Second Circuit expressly adopted *Cady, Roberts’* disclose or abstain rule under a theory of equal access to information.”). But the SEC’s “triumph of the equal access theory in *Texas Gulf Sulphur* was not to abide” since “[i]n *Chiarella v. United States*, the Supreme Court took the opportunity to trim back the broad prohibition of *Texas Gulf Sulphur* by rejecting the equal access theory” and the “insistence on informational parity and identical market risks.” *Id.* at 271–72. Currently, the “equal access theor[y] for Section 10(b) objectives [is] ‘dead.’” Marc I. Steinberg, *Insider Trading Regulation—A Comparative Analysis*, 37 INT’L LAW. 153, 155 (2003).

² See *United States v. O’Hagan*, 521 U.S. 642, 651–52 (1997) (emphasizing the fiduciary relationship between shareholders and insiders).

³ 445 U.S. 222 (1980).

⁴ See *id.* at 227 (“[The SEC], and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.” (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961))); see also *Dirks v. SEC*, 463 U.S. 646, 660 n.21 (1983) (“[A]n insider has to observe what has come to be known as the abstain or disclosure rule. Either the information has to be disclosed to the market if it is inside information . . . or the insider must abstain.” (quoting Transcript of Oral Argument at 27, *Dirks*, 463 U.S. 646 (No. 82-276))); *Cady, Roberts*, 40 S.E.C. at 911 (adopting the disclose or abstain rule in an SEC proceeding).

⁵ See *O’Hagan*, 521 U.S. at 651–52.

⁶ This Note uses the SEC’s definition of “sophisticated,” which is a person who “has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.” 17 C.F.R. § 230.506(b)(2)(ii) (2007). For a good discussion of the factors considered in determining a party’s sophistication, see 7C J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 11.08[2][b] (1st ed. rev. 1988).

⁷ In Rule 10b-5 actions, a fact is material if a plaintiff can establish “a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote,” taking into account “the ‘total mix’ of information made available.” *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); accord *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988).

⁸ The distinction between nonpublic and public information is inexact. The SEC maintains that information is public once it has “been effectively disclosed in a manner sufficient to insure its availability to the investing public.” *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968) (en banc). This Note uses the *Texas Gulf Sulphur* definition. For a good discussion of what constitutes nonpublic information, see RALPH C. FERRARA, DONNA M. NAGY & HERBERT THOMAS, FERRARA ON INSIDER TRADING AND THE WALL § 2.01[2] (2007).

Indeed, such an agreement is the fundamental concept of a big boy letter.⁹ Big boy letters are agreements between parties to a securities transaction where one party, typically the seller, has material, nonpublic information that it does not want to disclose,¹⁰ but both parties want to complete the transaction and preclude any claims based on the nondisclosure.¹¹ Though widely used in securities transactions for years,¹² the terms of a big boy letter vary, yet standard provisions include representations by the signatory that: it is financially sophisticated; it is aware that the counterparty may have material, nonpublic information that may affect the value of the traded securities; it realizes that it is not privy to any such information, if there is any; it is not relying on any of its counterparty's nondisclosures, if there are any; it is not relying on any representations not expressly set forth in the big boy letter; it is waiving all claims against its counterparty arising out of the nondisclosure; and finally, it realizes the effect of this waiver and elects to proceed with the transaction, essentially stating, "I am a big boy."¹³

Big boy letters have received much attention in recent months on account of two cases involving big boy letters and a *New York Times*

⁹ See Karl A. Groskaufmanis & Kalman Ochs, *Revisiting Insider Trading in the Debt Markets: Lessons for Debt Investors and Members of Committees in Bankruptcy Cases*, 8 J. INVESTMENT COMPLIANCE, No. 4, 2007, at 22, 24 [hereinafter *Revisiting Insider Trading*] ("Big boy letters are agreements under which market participants make a business decision to move forward with a transaction with advance knowledge that one party may have undisclosed material information.")

¹⁰ There are several reasons why this party (typically the seller) would not want to disclose the nonpublic information. In many instances, the seller acquired that information pursuant to a confidentiality agreement with a third party, thereby inhibiting the seller from disclosing the information without violating other duties. Even if the seller were willing and able to disclose the nonpublic information, the counterparty may be unwilling to accept it, as it may wish to resell the securities without the worry of possessing nonpublic information. The issue of reselling securities after acquiring them with a big boy letter is discussed in Part V.A. See Stephen R. Hertz, *Do Big-Boy Letters Really Work?*, 3 DEBEVOISE & PLIMPTON: THE PRIVATE EQUITY REPORT (Debevoise & Plimpton LLP), No. 3, Spring 2003, at 5, <http://www.debevoise.com/files/Publication/2736c2ae-9f14-4dee-b653-982519a39ac1/Presentation/PublicationAttachment/aa138944-92c4-44ef-8a6e-d30d0532e511/Spring%202003.pdf>.

¹¹ See Randall W. Bodner et al., *Big Boy Letters in the Spotlight*, INSIGHTS: CORP. & SEC. L. ADVISOR, June 2007, at 2, 2.

¹² See *id.*; see also Stephen E. Older & Joshua M. Bloomstein, *Cutting "BIG BOYS" Down to Size*, MERGERS & ACQUISITIONS: DEALMAKER'S J., Dec. 2003, at 38, 39 (noting that big boy letters "have come into increasing use in transactions involving sales of publicly traded securities, including mergers, acquisitions, and divestitures."); Josh Stoffregen, *Big Boy Letters No Shield, Says SEC*, COMPLIANCE REPORTER, Nov. 16, 2007, LexisNexis Academic.

¹³ See Bodner et al., *supra* note 11, at 2; *Revisiting Insider Trading*, *supra* note 9, at 24; Hertz, *supra* note 10, at 5; Rachel McTague, *In Insider Case, Big Boy Letter Signatory Need Not Have Been Deceived, Official Says*, 39 Sec. Reg. & L. Rep. (BNA) 1893 (Dec. 10, 2007) [hereinafter McTague, *In Insider Case*]; Older & Bloomstein, *supra* note 12, at 38–39. For a form big boy letter, see THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISORS app. F8 (2007).

article on the topic.¹⁴ The first case was an SEC enforcement action against Barclays in May 2007.¹⁵ The SEC charged Barclays and its head proprietary trader of distressed U.S. debt with violating Rule 10b-5 by trading securities while in possession of material, nonpublic information about the corporate issuers.¹⁶ The trader allegedly obtained this information by participating in various bankruptcy creditors committees.¹⁷ Although the proprietary trader used big boy letters in several of the transactions,¹⁸ the SEC still brought an enforcement action. Without admitting or denying any wrongdoing, Barclays and the proprietary trader agreed to pay a combined \$11.69 million to settle the matter.¹⁹

The second case, *R² Investments LDC v. Salomon Smith Barney*, was a private suit that commenced in April 2001.²⁰ Salomon Smith Barney (now Smith Barney) had sold more than \$20 million of high-yield World Access bonds to Jeffries & Company, an investment bank, using a big boy letter.²¹ Jeffries immediately resold those bonds to R², allegedly without informing R² that it had signed a big boy letter with Salomon when purchasing the notes.²² A few days after R² acquired the bonds, World Access “disclosed disappointing earnings and other negative financial information.”²³ Upon this news, the market value of the bonds plunged by over thirty percent.²⁴ Six years after R² filed the complaint, the parties settled the matter.²⁵

In addition to these two cases, big boy letters are an important issue because they are very common in the financial industry, yet they occupy a gray area of the law.²⁶ Corporate attorneys disagree on the issue.²⁷ To date, no court has ruled on the enforceability or effect of

¹⁴ Jenny Anderson, *Side Deals in a Gray Area*, N.Y. TIMES, May 22, 2007, at C1.

¹⁵ SEC v. Barclays Bank PLC, No. 07-CV-04427 (S.D.N.Y. May 30, 2007).

¹⁶ Complaint ¶¶ 1-7, *Barclays Bank*, No. 07-CV-04427.

¹⁷ *Id.*

¹⁸ *Id.* ¶ 18.

¹⁹ Barclays Bank Pays \$10.9 Million to Settle Charges of Insider Trading on Bankruptcy Creditor Committee Information, Litigation Release No. 20,132 (May 30, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20132.htm>.

²⁰ R² Invs. LDC v. Salomon Smith Barney, No. 01-CV-03598 (S.D.N.Y. Apr. 27, 2001).

²¹ Bodner et al., *supra* note 11, at 4.

²² *Id.* at 4.

²³ *Id.* at 5.

²⁴ Anderson, *supra* note 14. The price of the notes dropped to \$360 per \$1,000 bond, whereas R² just recently bought the bonds for \$501.875 per \$1,000 bond. *Id.*

²⁵ See *When Creditors are Traders, Gray Areas Arise*, DISTRESSED INVESTING REP. (Turnaround Mgmt. Ass’n, Chicago, Ill.), Apr. 2008, at 16, available at http://www.turnaround.org/cmaextras/DI_report.FINAL.pdf.

²⁶ See Bodner et al., *supra* note 11, at 2 (“[R]ecent developments raise anew the long-standing question of whether such ‘big boy’ letters are enforceable.”).

²⁷ See Anderson, *supra* note 14 (interviewing practitioners at more than a dozen law firms “elicit[ed] a wide range of opinions on big-boy letters.”).

big boy letters.²⁸ *R*² was the first and only case in the United States that concerned big boy letters.²⁹ As *R*² settled, judicial analysis of big boy letters is still lacking. In addition, the SEC has never issued any official guidance on big boy letters.³⁰ Finally, discourse on big boy letters is, at best, scant in legal academic literature.³¹

Perhaps most interesting is that, despite the prevalence of big boy letters and their unresolved legal status,³² *R*² was the only private suit concerning them.³³ Apparently, big boy letters have the invaluable effect of preventing costly litigation. The circumstances surrounding big boy letters reveal an explanation for this phenomenon. Big boy letters are contracts between sophisticated parties who are repeat players in the financial markets.³⁴ As such, these parties must act with integrity to protect their brand and reputation.³⁵ By signing a big boy letter, the signatory agrees not to sue its counterparty regarding any

²⁸ Bodner et al., *supra* note 11, at 5; *see also Revisiting Insider Trading, supra* note 9, at 24 (“The use of big boy language has evolved with little direct guidance from the courts . . .”).

²⁹ *See* Anderson, *supra* note 14, (observing that with the *R*² case, “[t]he use of big-boy letters is about to face its first significant legal challenge”). An analysis of Judge Easterbrook’s and Judge Posner’s opinions in *Jordan v. Duff & Phelps, Inc.*, however, reveals that they would support the enforceability of big boy letters. *See* *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 436 (1987) (Easterbrook, J.); *id.* at 445–51 (Posner, J., dissenting); M. Todd Henderson, *Deconstructing Duff and Phelps*, 74 U. CHI. L. REV. 1739, 1754 (2007) (“One thing upon which Easterbrook and Posner agree is that the parties could, through contract, waive any duties to disclose . . .”).

³⁰ Anderson, *supra* note 14 (“The Securities and Exchange Commission has not weighed in on [big boy] letters.”). Within the past several months, however, four officials at the SEC have made public comments regarding big boy letters in the context of an SEC enforcement action. *See* Rachel McTague, ‘Big Boy’ Letter Not a Defense to SEC Insider Trading Charge, *Official Says*, 39 Sec. Reg. & L. Rep. (BNA) 1832 (Dec. 3, 2007) [hereinafter McTague, *Not a Defense*] (reporting remarks of Fredric Firestone, SEC Associate Director); McTague, *In Insider Case, supra* note 13, at 1893 (noting reflections of David Rosenfeld, SEC Associate Regional Director); Stoffregen, *supra* note 12 (recording analyses by Doug Scheidt, SEC Associate Director, and Thomas Biolsi, SEC Associate Regional Director). Although the assertions of individual staff members do not reflect an official position by the SEC, the statements are notable nonetheless. *See infra* Part IV for a discussion of big boy letters and SEC enforcement actions.

³¹ At the time of publication, in addition to this Note, only two contemporaneous, independently developed works commenting on big boy letters have been published in legal academic literature.

³² Wendell H. Adair, Jr. & Brett Lawrence, *Big Boy Letters: Playing it Safe After O’Hagan*, J. CORP. RENEWAL, June 1, 2004, available at <http://www.turnaround.org/Publications/Articles.aspx?objectID=3342> (“[T]here is almost no jurisprudence concerning big boy letters . . .”).

³³ *See supra* notes 28–29 and accompanying text.

³⁴ These repeat players are almost always institutional investors, including hedge funds, private equity funds, pension funds, investment banks, insurance companies, and broker-dealers. *See Revisiting Insider Trading, supra* note 9, at 24.

³⁵ *See* AHMED RIAHI-BELKAOUI, THE ROLE OF CORPORATE REPUTATION FOR MULTINATIONAL FIRMS, at xv (2001). (“The reputation of a firm is central to the success of the decisions and positions taken by management. It embodies the firm’s total organizational effectiveness. A good reputation is an effective market signal resulting from a firm’s suc-

nondisclosure. Thus, the signatory may not be able to afford the reputational costs of going back on its word by suing the counterparty. In the financial industry, trust and reputation are arguably a firm's most valuable assets.³⁶

Against this backdrop, it is necessary to take a critical look at this controversial practice and to examine the legal enforceability of big boy letters. This Note argues for the enforceability of big boy letters in negotiated, face-to-face transactions between sophisticated parties. This Note then argues that even if courts refuse to enforce the waiver clause of a big boy letter, the big boy letter can still preclude a Rule 10b-5 suit. Part I of this Note provides background on the various securities laws at play and outlines the rise of big boy letters. Part II contends that big boy letters should be enforceable despite the anti-waiver provision of the Securities Exchange Act. Part III argues that, even if big boy letters are void under the anti-waiver provision, there is still no fraud or deception in a transaction involving big boy letters. Part III also argues that big boy letters disqualify claims of reasonable reliance. The absence of either fraud or reasonable reliance would thereby obviate a Rule 10b-5 allegation. Part IV explores big boy letters in the context of SEC enforcement actions. Part V investigates several problems produced by big boy letters and discusses potential answers to those problems.

I

THE EMERGENCE OF BIG BOY LETTERS

Section 10(b) of the Securities Exchange Act of 1934 authorized the SEC to regulate the use of manipulative³⁷ and deceptive devices in connection with the purchase or sale of any security.³⁸ Rule 10b-5,³⁹

cessful organizational market effectiveness. Corporate reputation has a crucial role in the market valuation of the firm . . .").

³⁶ See *id.*; see also *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 438 (1987) ("[A] firm's desire to preserve its reputation is a powerful inducement to treat its contractual partners well.").

³⁷ Manipulation is largely a term of art and does not directly apply to insider trading. The term refers to the artificial control of the price of a security, which is not an issue with big boy letters. Steven A. Ramirez & Christopher M. Gilbert, *The Misappropriation Theory of Insider Trading Under United States v. O'Hagan: Why Its Bark is Worse Than Its Bite*, 26 SEC. REG. L.J. 162, 164 n.8 (1998).

³⁸ See 15 U.S.C. § 78j (2006).

³⁹ Rule 10b-5 provides in full:

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,

(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

promulgated under section 10(b), prohibits any fraud or deceit—the making of untrue statements of material facts or the omission of material facts—in connection with the purchase or sale of any security.⁴⁰ A judicially created implied right of action under Rule 10b-5 allows private parties to bring Rule 10b-5 claims.⁴¹ Over the years, Rule 10b-5 has developed into the SEC’s principal tool to combat insider trading.⁴² As the SEC enacted Rule 10b-5 pursuant to section 10(b), the Supreme Court has repeatedly proclaimed that the reach of Rule 10b-5 cannot exceed that of section 10(b).⁴³

The Supreme Court, at first, certified Rule 10b-5 liability for insider trading under the classical theory.⁴⁴ Under this theory, corporate insiders, such as officers and directors, cannot trade the securities of their corporation if they possess material, nonpublic information; such knowledge gives rise to a duty to disclose or abstain from trading.⁴⁵ The classical theory relies on two principal elements.⁴⁶ First, by virtue of their access to material, nonpublic information, insiders owe a duty to their corporation and their shareholders to use such information to further the corporation’s interest, rather than to advance their personal pecuniary interest.⁴⁷ Second, it is inherently unfair if a corporate insider exploits knowledge of material, nonpublic information to take advantage of an unwitting counterparty.⁴⁸

Seventeen years later, in *United States v. O’Hagan*,⁴⁹ the Supreme Court sanctioned the misappropriation theory of insider trading.⁵⁰ Under the misappropriation theory, unlike the classical theory, a party owes a duty not to the issuing corporation, or its shareholders, or the trading counterparty, but rather to the source of the material, nonpublic information on which that party trades.⁵¹ This duty persists even if the source of the information has no connection to the corpo-

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2003).

⁴⁰ See *id.*; ALLEN ET AL., *supra* note 1, at 643–45.

⁴¹ See FERRARA ET AL., *supra* note 8, § 3.01.

⁴² See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION* 629 (4th ed. 2004).

⁴³ See, e.g., *United States v. O’Hagan*, 521 U.S. 642, 651 (1997); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213–14 (1976).

⁴⁴ See *O’Hagan*, 521 U.S. at 651–52 (citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980)); see also *Dirks v. SEC*, 463 U.S. 646, 653–54 (1983).

⁴⁵ See *O’Hagan*, 521 U.S. at 651–52.

⁴⁶ See *Chiarella*, 445 U.S. at 226–27 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961)).

⁴⁷ See *id.*

⁴⁸ See *id.*

⁴⁹ 521 U.S. 642 (1997).

⁵⁰ See *id.* at 652–53.

⁵¹ *Id.*

rate issuer.⁵² Thus, the premise for liability is a deception of the source of the nonpublic information, and not of the issuing corporation or the counterparty.⁵³ *O'Hagan* implies that a trader in possession of material, nonpublic information could avoid liability under Rule 10b-5 by revealing an intention to trade to the source of the information,⁵⁴ even if the trader never discloses the material, nonpublic information to its trading counterparty.⁵⁵ This liability carve-out in *O'Hagan* subsequently gave birth to the idea of big boy letters—agreements that allow a party to trade on material, nonpublic information without having to disclose any such information.⁵⁶

Practitioners then drafted big boy letters, seeking to avoid Rule 10b-5 liability by having their counterparties disclaim reliance on, and waive any future claims arising out of, the nondisclosures.⁵⁷ But this tactic implicates the anti-waiver provision of the Exchange Act, section 29(a), which reads in full: “Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.”⁵⁸ Although the language of section 29(a) casts doubt on the enforceability of big boy letters, practitioners continue to rely on them heavily.

II

BIG BOY LETTERS SHOULD BE ENFORCEABLE DESPITE SECTION 29(A)

A. Signatory Does Not Waive a Potentially Meritorious Claim

The threshold issue regarding the enforceability of big boy letters in private suits is whether they are enforceable under the anti-waiver provision of the Exchange Act, section 29(a).⁵⁹ The Supreme Court provided some insight into this issue in *Shearson/American Express, Inc.*

⁵² *Id.* at 653 (“The misappropriation theory is thus designed to protect the integrity of the securities markets against abuses by ‘outsiders’ to a corporation who have access to 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.”) (internal citation omitted).

⁵³ *See id.* at 656 (“[T]he person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.”).

⁵⁴ *See id.* at 655 (“Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation . . .”).

⁵⁵ Adair & Lawrence, *supra* note 32.

⁵⁶ *See id.*; *see also* LEMKE & LINS, *supra* note 13, § 2.169 n.1 (noting that big boy letters derive some support from *United States v. O'Hagan*).

⁵⁷ *See supra* note 13 and accompanying text.

⁵⁸ 15 U.S.C. § 78cc (2006).

⁵⁹ Recall that a signatory to a big boy letter waives all claims related to the nondisclosure of the material, nonpublic information. *See supra* note 13 and accompanying text.

v. McMahon,⁶⁰ which remains the law on the interpretation of the anti-waiver provision. The plaintiffs in the case were Eugene and Julia McMahon, customers of Shearson/American Express (Shearson), an SEC-registered brokerage firm.⁶¹ Julia McMahon signed customer agreements with Shearson that provided for arbitration of any controversy relating to any of the McMahons' accounts.⁶² When the McMahons filed suit against Shearson alleging, inter alia, that Shearson violated section 10(b) and Rule 10b-5, Shearson moved to compel arbitration.⁶³ The district court held that the allegations were arbitrable,⁶⁴ but the Second Circuit reversed, concluding that the arbitration agreement waived compliance with section 27 of the Exchange Act⁶⁵ and was therefore void under section 29(a).⁶⁶

The Supreme Court reversed the Second Circuit, declaring that section 29(a) forbids the "enforcement of agreements to waive '*compliance*' with the provisions of [the Exchange Act]" or "waiver[s] of the substantive obligations imposed by the Exchange Act."⁶⁷ Since section 27 does not itself impose any statutory duty, the arbitration agreement did not violate section 29.⁶⁸ The Court then said that the relevant section 29(a) inquiry is "whether the agreement 'weaken[s] [one's] ability to recover under the [Exchange] Act'"⁶⁹ and that an arbitration agreement would not do so.⁷⁰ The Court added that the voluntariness of such an agreement is irrelevant—"if a stipulation waives compliance with a statutory duty, it is void under section 29(a), whether voluntary or not."⁷¹

The interpretation of section 29(a) by other courts is instructive as well. In *Korn v. Franchard Corp.*,⁷² the Southern District of New York upheld a broad release of a matured claim made by a sophisticated party who had knowledge of the claim.⁷³ The court relied on *Wilko v. Swan*⁷⁴ to support the proposition that section 29(a) prohibits antici-

60 482 U.S. 220 (1987).

61 *See id.* at 222–23.

62 *See id.* at 223.

63 *See id.*

64 *See* McMAHON v. SHEARSON/AM. EXPRESS, INC., 618 F. Supp. 384, 389 (S.D.N.Y. 1985).

65 Section 27 provides: "The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder." 15 U.S.C. § 78aa (2006).

66 *See* McMahon v. Shearson/Am. Express, Inc., 788 F.2d 94, 96–97 (2d Cir. 1986).

67 *Shearson/Am. Express, Inc.*, 482 U.S. at 228 (emphasis added).

68 *See id.*

69 *Id.* at 230 (quoting *Wilko v. Swan*, 346 U.S. 427, 432 (1953)).

70 *See id.* at 231–34.

71 *Id.* at 230.

72 388 F. Supp. 1326 (S.D.N.Y. 1975).

73 *See id.* at 1328–30.

74 346 U.S. 438 (1953).

patory waivers of compliance, not waivers of known and matured claims.⁷⁵ The Seventh Circuit took a further step, ruling that waivers of Rule 10b-5 claims that “should have [been] known upon reasonable inquiry” are valid as well.⁷⁶ Still, *Petro-Ventures, Inc. v. Takessian*⁷⁷ is the most promising for the practice of big boy letters. In that case, the Ninth Circuit, focusing on the sophistication of the parties, decided that even unknown securities claims could be waived without violating section 29(a).⁷⁸ Specifically, the court stated that when “a release is signed in a commercial context by parties in a roughly equivalent bargaining position and with ready access to counsel, the general rule is that, if ‘the language of the release is clear, . . . the intent of the parties [is] indicated by the language employed.’”⁷⁹

Perhaps counterintuitively, big boy letters do not constitute an impermissible waiver under section 29(a). Section 29(a) “forecloses anticipatory waivers of compliance with the duties imposed by Rule 10b-5.”⁸⁰ However, a party that demands a big boy letter does not seek a waiver of compliance with the securities laws; rather, it seeks only to preclude costly and meritless⁸¹ litigation relating to the nondisclosure of the nonpublic information.⁸² For an agreement to violate section 29(a), there must be a waiver of a potentially meritorious claim. As discussed below in Part III.A, no such claim exists with respect to big boy letters, since there is no duty to disclose the material, nonpublic information and since big boy letters are not deceptive or fraudulent. Essentially, the signatory to a big boy letter only waives its ability to file a suit that has no prospect of recovery anyway. In *Shearson* terms, a big boy letter does not “weaken” the signatory’s ability to recover under

⁷⁵ See *Korn*, 388 F. Supp. at 1329 (“To rule otherwise would foreclose the parties from settling matured claims and force every claimant to pursue the litigation to its costly conclusion.”).

⁷⁶ *Goodman v. Epstein*, 582 F.2d 388, 403 (7th Cir. 1978).

⁷⁷ 967 F.2d 1337 (9th Cir. 1992).

⁷⁸ See *id.* at 1342.

⁷⁹ *Id.* (alteration in original) (quoting *Locafrance U.S. Corp. v. Intermodal Sys. Leasing*, 558 F.2d 1113, 1115 (2d Cir. 1977)).

⁸⁰ *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 180 (3d Cir. 2003).

⁸¹ Part III.A explains that such litigation is meritless because in nearly all instances, the party with superior information is under no duty to disclose the material, nonpublic information. Nonetheless, even if there were a duty to disclose, the quasi-disclosure provided by big boy letters would satisfy any such duty. The signaling effect of big boy letters, together with the sophistication of the parties, obviates the need for full disclosure while concomitantly conforming to Rule 10b-5 jurisprudence. See *infra* Part III.A for a full discussion of these concepts. Even if any of these statements are untrue, it will be very difficult, if not impossible, for the big boy signatory to prove reasonable reliance. See *infra* Part III.B.

⁸² See *McTague*, *In Insider Case*, *supra* note 13, at 1893 (“The party with the undisclosed inside information wants insurance that its counterparty will not claim in the future that the counterparty was defrauded due to nondisclosure of the information . . .”).

the Exchange Act, since the signatory would not have been *able* to recover.⁸³

Why, then, do sophisticated parties insist on obtaining big boy letters? There are at least a few reasons. That big boy letters are not deceptive or fraudulent has yet to garner judicial support, given the lack of cases concerning them. Part III.A draws from relevant case law to argue that big boy letters are neither deceptive nor fraudulent. Understandably, corporate attorneys and institutional investors do not want to test these arguments in costly legal battles—they simply want to prevent such battles altogether. To that end, the party that demands a big boy letter believes that the counterparty, as a matter of principle, will live up to its promise and not pursue any legal action. The paucity of cases on big boy letters seems to indicate that they do indeed implement this sort of market discipline. Also, in the absence of a big boy letter, an aggrieved signatory, perhaps feeling cheated by the counterparty's information advantage, might be more likely to pursue legal action. Finally, the signaling effect of big boy letters, and the quasi-disclosure that they afford,⁸⁴ diminishes the chances of any *ex post* litigation. Big boy letters make it more difficult for the signatory to later claim that the counterparty deceived or defrauded it, particularly in light of the signatory's sophistication. In this sense, they provide a level of comfort to the party with the superior information.

B. Policy Considerations

An examination of the policies underlying the securities laws demonstrates that big boy letters between sophisticated parties are not the type of matter that concerned Congress when it passed the Securities Act of 1933 and the Securities Exchange Act of 1934 (the Acts). It is clear that the Acts were “primarily designed with the protection of investors in mind.”⁸⁵ In particular, the Acts “were intended to safeguard investors from overreaching by industry professionals who held inherently superior bargaining positions.”⁸⁶ A principal aim of Con-

⁸³ As clarified in Part III.A, the signatory cannot recover for any claim arising from the nondisclosure of material, nonpublic information. However, the signatory can recover if, for example, the counterparty made misleading disclosures. That a big boy letter is a limited waiver applying only to claims relating to the nondisclosure is significant in establishing its enforceability. A more sweeping waiver could violate section 29(a) if it compromised any potentially meritorious claims that the signatory might have. *See infra* Part III.A.

⁸⁴ *See infra* Part III.

⁸⁵ *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 246 (1987) (Blackmun, J., concurring in part and dissenting in part); *see also* Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879, 891 (1994) (“[T]he 1933 and 1934 Acts were enacted in significant measure for the protection of investors.”).

⁸⁶ Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 576 (1999); *see also* C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1133

gress was to redress the rampant fraud that average investors faced in the financial markets,⁸⁷ where those with greater knowledge and bargaining power were swindling investors. One author notes that “a fundamental purpose of the securities laws is to protect those who cannot protect themselves.”⁸⁸ Another argues that, “except for the 1934 Act’s margin provisions, the [1933 and 1934] Acts’ legislative history shows that nearly every provision was motivated, either directly or indirectly, by concerns with predation on individual investors.”⁸⁹ Such fears are absent when it comes to big boy letters, which are agreements between sophisticated parties with equal bargaining power,⁹⁰ each presumably advised by competent counsel.

That the securities laws are not concerned with dealings among sophisticated parties is evident upon inspection of the 1933 Securities Act. One example is section 4(2).⁹¹ Private offerings of securities can take place without compliance with the registration and prospectus delivery requirements of the Securities Act through reliance on the exemption provided by section 4(2), which applies to transactions by an issuer not involving a public offering.⁹² Prior to 1982, the SEC

generally required an issuer seeking to rely on section 4(2) to make a subjective determination that each offeree had sufficient knowledge and experience in financial and business matters to enable that offeree to evaluate the merits of the prospective investment or that such offeree was able to bear the economic risk of the investment.⁹³

In other words, the offeree must have been a sophisticated investor. The SEC adopted Regulation D to alleviate some of the uncertainty inherent in making such a subjective determination and “to establish non-exclusive ‘safe harbor’ criteria for the section 4(2) private offer-

(“As a historical matter, Congress did not design the securities laws to protect investors capable of protecting themselves.”).

⁸⁷ See Fletcher, *supra* note 86, at 1133.

⁸⁸ Welle, *supra* note 86, at 545.

⁸⁹ Fletcher, *supra* note 86, at 1134.

⁹⁰ Bargaining power does not refer solely to the relative strength of a party’s negotiating position. It also refers to a party’s ability to protect itself during the transaction, e.g., by its sophistication, by conducting due diligence and other research, by proceeding with the guidance of lawyers, by pressing for contractual protections, etc.

⁹¹ 15 U.S.C. § 77d(2) (2006).

⁹² See 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 4.1[2] (5th ed. 2005) (noting that the exemption in § 4 “dispense[s] with the 1933 Act’s registration and prospectus delivery requirements”); see also 1 *id.* § 4.24[1] (“Section 4(2) of the 1933 Act exempts ‘transactions not involving any public offering’ and is ‘commonly referred to as the private placement exemption.’”). See generally 1 *id.* § 4.24[1] (elaborating on the scope of the section 4(2) exemption).

⁹³ Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 403 (Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230 and 275).

ing exemption.”⁹⁴ Under Rule 506 of Regulation D, an issuer may sell its securities to a fixed number of sophisticated investors and an unlimited number of accredited investors without complying with the registration requirements of the Securities Act, unless the issuer is subject to another restriction.⁹⁵ In turn, Rule 501 of Regulation D often defines an accredited investor by monetary benchmarks.⁹⁶ The SEC uses wealth as a proxy for sophistication, presuming that wealthy individuals are knowledgeable and experienced enough not to require all the protections of the securities laws.⁹⁷ Such sophisticated parties do not lack bargaining power and are capable of protecting themselves.⁹⁸

The Supreme Court agrees with the above reasoning. The Court defines a private offering as “[a]n offering to those who are shown to be able to fend for themselves.”⁹⁹ A private offering exemption, like that permitted under section 4(2), pertains to transactions “where there is no practical need” for the application of the Securities Act.¹⁰⁰ Consequently, the availability of the exemption “should turn on whether the particular class of persons affected need[s] the protection of the Act.”¹⁰¹ Sophisticated or wealthy parties, apparently, do not need all the protections of the securities laws.

There are still other instances where the securities laws make exceptions for sophisticated investors. Section 4(6) of the Securities Act exempts “transactions involving offers or sales by an issuer solely to one or more accredited investors” from the registration and prospectus delivery requirements, so long as the aggregate offering price does not exceed \$5 million.¹⁰² SEC Rule 144A provides safe harbor from the registration requirements of the Securities Act for private resale of restricted securities to qualified institutional buyers (QIBs).¹⁰³ A QIB is any institution that owns more than \$100 million worth of investable

⁹⁴ *Id.* at 404.

⁹⁵ See Fletcher, *supra* note 86, at 1123 (“Neither category of sales—to accredited investors or to sophisticated investors—requires registration, presumably because neither group requires the protections that registration affords.”).

⁹⁶ See 17 C.F.R. § 230.501(a) (2007).

⁹⁷ See Fletcher, *supra* note 86, at 1124 (“[T]he SEC assumes either that wealthy investors are always sophisticated or that they, no matter how naive, do not need the protection of the 1933 Act’s registration provisions.”). The naive but wealthy investor who lacks knowledge or experience at least has enough financial resources to purchase expert advice and benefit from the judgment of a professional.

⁹⁸ See 1 HAZEN, *supra* note 92, § 4.24[1] (“The exemption for non-public offerings applies to offerings to institutional investors that are sufficiently sophisticated and have sufficiently strong bargaining positions that they do not need the protections of federal registration.”).

⁹⁹ SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

¹⁰⁰ *Id.* at 122 (quoting H.R. REP. NO. 73-85, at 5 (1933)).

¹⁰¹ *Id.* at 125.

¹⁰² 15 U.S.C. § 77d(6) (2006).

¹⁰³ See 17 C.F.R. § 230.144A (2007).

assets.¹⁰⁴ Although Rule 144A only applies to a limited class of securities, it allows QIBs to trade among themselves *ad infinitum* without having to adhere to the Act's registration requirements.¹⁰⁵ Accordingly, it is clear that the SEC often relaxes securities laws for sophisticated and wealthy parties, as they have the knowledge, experience, and bargaining power to protect themselves.

The foregoing illustrates why big boy letters, agreements between sophisticated parties with equal bargaining power, should be enforceable under section 29(a) of the Exchange Act. Although the legislative and administrative histories of section 29(a) are silent as to whether a defendant can assert a waiver defense,¹⁰⁶ the principles and policies of securities laws demand that big boy letters receive judicial enforcement. Congress's concern for protecting the investor is incongruent with the realities of big boy transactions, where sophisticated parties negotiate with equal bargaining power, and can thus protect themselves. There is no worry that a hedge fund will pull the wool over the eyes of an investment bank.

III

BIG BOY LETTERS OFFER PROTECTION EVEN IF THEY ARE NOT ENFORCEABLE UNDER SECTION 29(A)

Suppose that *Seller* and *Buyer*, both sophisticated parties, initiate a discussion for the sale of securities. At the very outset, *Seller* informs *Buyer* that the latter will need to sign a big boy letter to consummate any such sale. Immediately, *Buyer* realizes several key points. That *Seller* is asking for a big boy letter notifies *Buyer* that *Seller* has nonpublic information and that such information is material¹⁰⁷ to the sale. If neither of these were true, there would be no need for a big boy letter

¹⁰⁴ See *id.* § 230.144A(1)(i).

¹⁰⁵ See 1 HAZEN, *supra* note 92, § 4.30[4] ("Indeed, the rule contemplates the formation of an active trading market in Rule 144A securities, in which qualified institutions and dealers can enter bids and offers.").

¹⁰⁶ 5D ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 19:32 (2008) ("Having defined the defense of waiver, the next question is when defendants in 10b-5 cases can assert it successfully. Not surprisingly, the legislative and administrative histories of the Rule shed no light on this issue."); see also Note, *Applicability of Waiver, Estoppel, and Laches Defenses to Private Suits Under the Securities Act and S.E.C. Rule 10b-5: Deterrence and Equity in Balance*, 73 YALE L.J. 1477, 1480 (1964) ("The Securities Act does not explicitly state whether [a waiver] defense[] can be used in actions under the civil liabilities sections. The legislative history, moreover, contains no evidence of congressional intent on the precise issue.").

¹⁰⁷ The information must be material in some sense, otherwise a rational party would not incur the additional costs required to obtain a big boy letter. The principal cost is the discount that *Seller* must offer on the underlying securities. Other costs include the time and resources spent negotiating and drafting the big boy letter. It is plausible, however, that a rational party would want a big boy letter even if it does not possess any material information. See *infra* Part V.C.

in the first place. Moreover, that *Seller* is looking to trade the securities, combined with the fact that *Seller* has material, nonpublic information, signals to *Buyer* that the information that *Seller* has must be adverse. If the nonpublic information was indeed positive, *Seller* would surely hold the securities until the good news materialized, so that *Seller* could reap the benefits.

At this point, *Buyer* has two options—either *Buyer* can decline to transact with *Seller* altogether or, fully appreciating the various risks involved, *Buyer* can voluntarily move forward with the sale and sign a big boy letter, knowing that *Seller* possesses adverse, material, nonpublic information that *Seller* will not disclose to *Buyer*. This Note argues that if *Buyer* opts for the second option, the big boy letter should be enforceable to preclude any claims arising out of the nondisclosures.

While *Seller* never transfers to *Buyer* the substance of the nonpublic information, *Buyer* does receive a powerful signal as to its qualitative characteristics, which serves as quasi-disclosure of the nonpublic information. If *Buyer* is at all uncertain about the nature of the information, *Buyer* can still discover it during negotiations. In the above example, *Buyer* is confident that *Seller* possesses unfavorable information regarding the underlying security. As such, *Buyer* will demand a discount on the purchase price of the securities. If the nonpublic information were either positive or neutral, *Seller* would never trade the securities at below-market prices. Thus, if *Seller* is willing to trade the securities at a below-market price, this confirms *Buyer's* beliefs that the nonpublic information is adverse.¹⁰⁸

Despite the fact that *Buyer* does not have perfect information, the quasi-disclosure of the big boy letter informs *Buyer* as to the nature of the material, nonpublic information. This new information allows *Buyer* to update his beliefs regarding the underlying securities and to adjust his valuation of those assets. It may also prompt *Buyer* to investigate diligently the public issuer of the securities to gain more information. In any case, the information disparity between *Seller* and *Buyer* is not as great as it seems at first—*Buyer* receives a strong, albeit somewhat noisy, signal about the material, nonpublic information.

A. Big Boy Letters Are Not Deceptive or Fraudulent

The argument for big boy letters begins with *Chiarella v. United States*,¹⁰⁹ a seminal case that forms the “authoritative underpinnings of

¹⁰⁸ The signatory to any big boy letter requires this risk premium for taking ownership of the securities. The signatory will demand compensation (in the form of a reduced purchase price) for the inherent risks involved in trading with a more informed counterparty and for waiving any right to sue the counterparty for any nondisclosures.

¹⁰⁹ 445 U.S. 222 (1980).

insider trading law under Rule 10b-5."¹¹⁰ Chiarella was a financial printer working in New York.¹¹¹ He handled various documents, including announcements of corporate takeover bids.¹¹² Although these documents did not show the identities of the acquiring and target corporations, Chiarella was able to deduce the names of the target corporations from other information in the documents.¹¹³ Chiarella traded on this material, nonpublic information, without ever disclosing it, and was able to turn a handsome profit.¹¹⁴ Yet the Supreme Court overturned Chiarella's conviction under section 10(b) and Rule 10b-5.¹¹⁵

The Court first looked to *Cady, Roberts*¹¹⁶ and stated that insiders cannot trade shares of their corporation without first disclosing all material, nonpublic information.¹¹⁷ In other words, the Court endorsed the disclose or abstain rule, but restricted its application to corporate insiders.¹¹⁸ Since an insider is in a position of trust and confidence with a fiduciary duty to the shareholders, the insider cannot cheat those shareholders by trading in the corporation's securities on the basis of material, nonpublic information.¹¹⁹ Consequently, in the absence of such a special relationship, there can be no violation of the disclose or abstain rule, and hence no breach of Rule 10b-5.¹²⁰ As Justice Powell wrote for the majority, "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so," and "the duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."¹²¹

The Court reversed Chiarella's conviction because he was not an insider and had no relationship with the shareholders of the target companies.¹²² In doing so, it explicitly refused to apply the disclose or

¹¹⁰ ALLEN ET AL., *supra* note 1, at 661.

¹¹¹ *Chiarella*, 445 U.S. at 224.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *See id.* Prior to Chiarella's indictment, he reached an agreement with the SEC to disgorge his profits to the people with whom he traded. *Id.*

¹¹⁵ *See id.* at 237.

¹¹⁶ 40 S.E.C. 907 (1961).

¹¹⁷ *See supra* notes 1-4 and accompanying text.

¹¹⁸ *See Chiarella*, 445 U.S. at 226-28.

¹¹⁹ *See* 445 U.S. at 227-28, 232-33.

¹²⁰ *See id.* at 232-33 ("[T]he element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.").

¹²¹ *Id.* at 228 (internal citations omitted).

¹²² *See supra* note 20 and accompanying text.

abstain rule to every person with material, nonpublic information.¹²³ The Court stated that “not every instance of financial unfairness constitutes fraudulent activity under § 10(b)”¹²⁴ and concluded:

When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of § 10(b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.¹²⁵

Chiarella thus bases section 10(b) liability on a breach of some duty, rather than on simple unfairness. Therefore, it is apparent that trading on the basis of material, nonpublic information, in and of itself, does not give rise to liability under *Chiarella*.¹²⁶

However, *Chiarella* alone does not validate the use of big boy letters. While trading on material, nonpublic information does not give rise to liability per se, a court could still find a disclosure or nondisclosure to be misleading under Rule 10b-5(b).¹²⁷ In the context of big boy letters, one must ask whether there is a duty to disclose the material, nonpublic information and whether a disclosure or nondisclosure is misleading.¹²⁸

Two recent Circuit Court decisions demonstrate that quasi-disclosure of material, nonpublic information identical in nature to that provided by big boy letters, in the framework of a securities transaction between sophisticated parties, does not give rise to Rule 10b-5 liability. In *McCormick v. Fund American Companies*,¹²⁹ the plaintiff, Mc-

¹²³ *Id.* at 233 (“We cannot affirm petitioner’s conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of congressional intent.”) (citation omitted).

¹²⁴ *Id.* at 232.

¹²⁵ *Id.* at 235.

¹²⁶ See *supra* notes 119–25 and accompanying text; see also *United States v. O’Hagan*, 521 U.S. 642, 690–91 (1997) (Thomas, J., concurring in part and dissenting in part) (“[A]s we have repeatedly held, use of nonpublic information to trade is not itself a violation of § 10(b).”; *Dirks v. SEC*, 463 U.S. 646, 657 (1983) (“Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading”) (emphasis added).

¹²⁷ Rule 10b-5(b) makes it unlawful 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.” 17 C.F.R. § 240.10b-5(b) (2007). Although manufacturing such misleading statements violates Rule 10b-5, it falls outside the scope of insider trading.

¹²⁸ One must also consider whether there is any misappropriation of confidential information. Part IV analyzes big boy letters in the context of the misappropriation theory.

¹²⁹ 26 F.3d 869 (9th Cir. 1994).

Cormick, was the CEO of a wholly owned subsidiary of the defendant, Fund American Companies (FAC).¹³⁰ A year after resigning from his position, McCormick agreed to sell all of his shares in FAC back to the firm.¹³¹ Prior to finalizing the sale, however, FAC informed McCormick that a foreign company might soon begin negotiations to purchase the subsidiary.¹³² FAC also informed McCormick that if such a deal were to go through, the value of his FAC shares would appreciate.¹³³ McCormick asked for the name of the foreign firm, but FAC declined to divulge any further information, asserting that such information was confidential.¹³⁴ McCormick then signed a document acknowledging that he had “been fully and adequately informed of the foregoing facts and circumstances,”¹³⁵ and the parties consummated the sale.¹³⁶

Sure enough, the foreign company purchased the FAC subsidiary and the value of FAC stock rose dramatically.¹³⁷ McCormick sued FAC for, inter alia, violating Rule 10b-5 by making a misleading misstatement or omission of material fact.¹³⁸ In affirming summary judgment against McCormick, the Ninth Circuit focused on FAC’s quasi-disclosure and McCormick’s sophistication.¹³⁹ The court found that FAC “neither disclosed nor failed to disclose; instead, it told the plaintiff that it had certain information (the name of the buyer), but that the information was confidential.”¹⁴⁰ McCormick voluntarily decided to sell his stock despite understanding that he was missing material facts. The court decided that, “particularly in light of McCormick’s considerable sophistication, [such] quasi-disclosure was sufficient.”¹⁴¹ Since “[t]he disclosures were accurate, and the information was adequate for McCormick to act upon,” there was no misrepresentation, no misleading conduct, no deceit, and no fraud.¹⁴²

In *Jensen v. Kimble*,¹⁴³ a similar issue confronted the Tenth Circuit. Kimble, a lawyer representing Sage Court Ventures, requested that Jensen, a shareholder of Sage Court, sell him nearly one million shares of Sage Court at below-market price.¹⁴⁴ Kimble informed Jen-

¹³⁰ *Id.* at 872.

¹³¹ *See id.*

¹³² *See id.* at 874.

¹³³ *See id.*

¹³⁴ *See id.* at 875.

¹³⁵ *Id.* at 874.

¹³⁶ *Id.* at 875.

¹³⁷ *See id.*

¹³⁸ *See id.*

¹³⁹ *See id.* at 879–80.

¹⁴⁰ *Id.* at 879.

¹⁴¹ *Id.*

¹⁴² *Id.* at 884.

¹⁴³ 1 F.3d 1073 (10th Cir. 1993).

¹⁴⁴ *See id.* at 1074–75.

sen that he was negotiating a sale for Sage Court and that Jensen's sale "could potentially solidify"¹⁴⁵ a takeover of Sage. Jensen asked Kimble to identify the other company and the players in the deal, but Kimble refused to divulge their identities.¹⁴⁶ Nonetheless, Jensen decided to proceed with the sale, testifying that he was "getting a good return on the stock being sold" and that "the sale still left them with a substantial number of shares upon which he hoped [he] would realize even greater profit after the deal was done."¹⁴⁷

The deal never materialized as the Kimble and Sage Court had envisioned, and Jensen eventually sued Kimble for making material misrepresentations and omissions in violation of Rule 10b-5.¹⁴⁸ The Tenth Circuit affirmed summary judgment against Jensen, stating that, "because Kimble specifically advised Jensen of [the] nondisclosures . . . Jensen sold [his] stock with full awareness of Kimble's omissions."¹⁴⁹ The court went on to say that "[e]ven when a relationship of trust exists between two parties, however, where the non-disclosing party explicitly informs the other party of his failure to disclose, an omission will not be misleading in the absence of special circumstances."¹⁵⁰ Such "special circumstances" include "the inability of the dependant party to understand or appreciate the significance of the undisclosed information."¹⁵¹ Such a situation did not exist in this case, as Jensen was a "very experienced, sophisticated investor who was under no compulsion to sell" his shares.¹⁵² Kimble "clearly notified Jensen that Kimble was not disclosing certain information with respect to the Sage Court deal."¹⁵³ Therefore, "by virtue of the disclosures that Kimble did make, Jensen knew what he didn't know."¹⁵⁴ As such, there was no misrepresentation, no misleading conduct, no deceit, and no fraud.¹⁵⁵

The foregoing rationale is directly applicable to trades involving big boy letters among sophisticated parties. In such trades, the signaling effect of big boy letters provides a level of quasi-disclosure of the

¹⁴⁵ *Id.* at 1075.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *See id.* at 1076.

¹⁴⁹ *Id.* at 1077.

¹⁵⁰ *Id.* at 1078 (emphasis added). The court continued to say that "[u]nder these circumstances, even assuming arguendo that a special relationship of trust existed between Jensen and Kimble, we do not believe it can be said that Kimble's omissions misled Jensen with respect to any of Kimble's other remarks." *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.* at 1078 n.9.

¹⁵³ *Id.* at 1078.

¹⁵⁴ *Id.*

¹⁵⁵ *See id.* ("Accordingly, even viewing the evidence in the light most favorable to the plaintiffs, we conclude that Kimble's omissions were neither manipulative nor deceptive within the meaning of Rule 10b-5 and thus are not actionable under this rule.")

nonpublic information, just as in *McCormick* and in *Jensen*. Depending on the circumstances, this quasi-disclosure will satisfy any disclosure obligations that a party may have, since full disclosure is not required absent a special relationship.¹⁵⁶ Even if a special relationship exists, an omission may not be misleading if the nondisclosing party informs the counterparty of the nondisclosure.¹⁵⁷ Like the plaintiffs in *Jensen* and in *McCormick*, the signatory to a big boy letter is a sophisticated party in a face-to-face transaction, alert to the information asymmetry and aware that its counterparty will not divulge certain material facts. Since the signatory knows what he does not know,¹⁵⁸ there can be no deceit or fraud, which are the gravamen of Rule 10b-5 liability.¹⁵⁹ Accordingly, the waiver clause of a big boy letter should be enforceable. Since there is no Rule 10b-5 violation, the signatory does not waive any potentially meritorious claim; any claim that the signatory brings relating to the nondisclosure will be meritless.

Furthermore, the signatory is under no obligation to carry out the transaction. The sophisticated signatory's voluntary decision to carry out the transaction is made with full appreciation of all the risks and possible outcomes of the trade. By carrying out the transaction, the signatory assumes the risks associated with it, thus preventing the signatory from later claiming that it was deceived or defrauded. Thus, the Second Circuit is correct in stating that where "a party has been put on notice of the existence of material facts which have not been documented and he nevertheless proceeds with a transaction . . . he may truly be said to have willingly assumed the business risk"¹⁶⁰ and therefore "will not be heard to complain that he has been defrauded."¹⁶¹ Indeed, "[t]he purpose of the [1934] Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the

¹⁵⁶ See *supra* notes 119–20, 139–41 and accompanying text.

¹⁵⁷ See *supra* note 150 and accompanying text.

¹⁵⁸ It is important for practitioners who draft big boy letters to specify the type of nonpublic information that is being withheld—e.g., business plans, financial projections, etc.—so that signatories are put on notice as to what they do not know and what they cannot rely on. As a corollary, big boy letters should be individually tailored for each transaction.

¹⁵⁹ See *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."). Indeed, absent any fraud, even a breach of fiduciary duty does not violate Rule 10b-5. See *Santa Fe Indus., Inc., v. Green*, 430 U.S. 462, 473–74 (1977) ("[T]he claim of fraud and fiduciary breach . . . states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute.").

¹⁶⁰ *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1543 (2d Cir. 1997) (citations omitted).

¹⁶¹ *Id.*

provisions of the Act.”¹⁶² Courts should not unwind transactions between sophisticated parties involving big boy letters.

B. Big Boy Letters Preclude Reasonable Reliance

Even if big boy letters are void under section 29(a), they can refute a plaintiff’s claim of reasonable reliance.¹⁶³ A private suit under Rule 10b-5 requires that the plaintiff prove reasonable reliance.¹⁶⁴ In a transaction involving big boy letters, the plaintiff’s allegations would presumably hinge, in one way or another, on the defendant’s nondisclosure of the material, nonpublic information. That is, the plaintiff would have to argue that the defendant’s failure to disclose the material, nonpublic information caused the plaintiff to consummate the transaction and that had the plaintiff received the material, nonpublic information beforehand, the plaintiff would not have proceeded with the transaction. However, a big boy letter shows that the signatory could not have possibly expected informational parity. Therefore, the signatory could not have reasonably relied on any nondisclosure.

Several cases support this reasoning. Most instructive are those cases that deal with non-reliance clauses,¹⁶⁵ which are analogous to big boy letters. Non-reliance clauses, often included in heavily negotiated purchase agreements,¹⁶⁶ specify that the buyer is relying only on those representations contained in the final written contract.¹⁶⁷ The aim of these clauses is to prevent an aggrieved party from subsequently claiming it relied on any oral or written representations excluded from the final agreement.¹⁶⁸ Similarly, the signatory to a big boy letter disclaims reliance on any withheld material, nonpublic information.¹⁶⁹ The Seventh Circuit succinctly summarized the thrust of the reasonable reliance argument, stating that “[s]ince reliance is an element of fraud, the [non-reliance] clause, if upheld—and why

¹⁶² *Royal Air Props., Inc. v. Smith*, 312 F.2d 210, 213–14 (9th Cir. 1962).

¹⁶³ See Older & Bloomstein, *supra* note 12, at 39–40 (“[E]ven if the ‘claim waiver’ provision of a big boy letter is invalidated, the non-reliance provision can serve as a ‘backstop’ defense to a claim under the SEC’s Rule 10b-5 dealing with fraudulent actions, since a plaintiff must, in most circumstances, prove ‘reasonable reliance’ to prevail.”).

¹⁶⁴ See *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

¹⁶⁵ Bodner et al., *supra* note 11, at 5–8 (“[S]ellers can hope to use non-reliance clauses or big boy representations as evidence of a buyer’s non-reliance at summary judgment or trial.”).

¹⁶⁶ *Id.* at 6.

¹⁶⁷ See *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 178 (2003) (explaining that the signatory to a non-reliance agreement “would be entitled to rely solely on the representations and warranties it would be able to secure in ‘any definitive agreement’”).

¹⁶⁸ See David K. Lutz, Note, *The Law and Economics of Securities Fraud: Section 29(a) and the Non-Reliance Clause*, 79 CHI.-KENT L. REV. 803, 804 (2004).

¹⁶⁹ See *supra* note 13 and accompanying text.

should it not be upheld, at least when the contract is between sophisticated commercial enterprises—precludes a fraud suit.”¹⁷⁰

In *Harsco Corp. v. Segui*,¹⁷¹ the plaintiff contracted to acquire all the stock of MultiServ, a Netherlands corporation.¹⁷² The definitive agreement included a set of representations,¹⁷³ as well as a non-reliance clause.¹⁷⁴ After closing, Harsco brought claims under Rule 10b-5 based on extra-contractual representations the defendant allegedly made,¹⁷⁵ and it argued that the non-reliance clause violated section 29(a).¹⁷⁶ The Second Circuit framed the issue as “whether parties who negotiate at arm’s length for the sale and purchase of a company can define the transaction in a writing so as to preclude a claim of fraud based on representations not made, and explicitly disclaimed, in that writing.”¹⁷⁷

In affirming the district court’s dismissal for failure to state a claim, the Second Circuit focused on the fact that “there [was] a detailed writing developed via negotiations among sophisticated business entities and their advisors.”¹⁷⁸ That writing “define[d] the boundaries of the transaction,” and “Harsco [brought the] suit principally alleging conduct that [fell] outside of those boundaries.”¹⁷⁹ Although for purposes of section 29(a) the non-reliance clause weakened Harsco’s ability to recover under the Exchange Act, “such a ‘weakening’ [did] not constitute a forbidden waiver of compliance.”¹⁸⁰ The Second Circuit focused on the sophistication of the parties and their equal bargaining power.¹⁸¹ The court then stated that the non-reliance provision did not completely bar Harsco from suing; rather, as one commentator noted, it “merely limited the universe of potentially actionable representations.”¹⁸² Any of the representations in the final agreement, if fraudulent, could have served as “the basis of a fraud action against the sellers.”¹⁸³ The Second Circuit adhered to

170 *Vigortone AG Prods., Inc. v. PM AG Prods., Inc.*, 316 F.3d 641, 645 (7th Cir. 2002).

171 91 F.3d 337 (2d Cir. 1996).

172 *See id.* at 340.

173 *Id.*

174 *See id.* at 342–43.

175 *See id.* at 341–42.

176 *See id.* at 343.

177 *Id.* at 339.

178 *Id.* at 343.

179 *Id.*

180 *Id.*

181 *See id.* at 344 (“[I]t is apparent from the complaint and the Agreement in this case that both Harsco and defendants were sophisticated business entities negotiating at arm’s length. The Agreement here reflects this relative parity.”).

182 Bodner et al., *supra* note 11, at 8.

183 *Harsco Corp.*, 91 F.3d at 344.

the *Harsco* court's reasoning seven years later in *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*¹⁸⁴

In *AES Corp. v. Dow Chemical Co.*,¹⁸⁵ AES agreed to acquire a subsidiary of Dow, pursuant to an asset purchase agreement.¹⁸⁶ This agreement contained a non-reliance provision.¹⁸⁷ Shortly after acquiring the subsidiary, AES brought a Rule 10b-5 suit against Dow, claiming reliance on representations absent in the final agreement.¹⁸⁸ Unlike the Second Circuit in *Harsco*, the Third Circuit ruled that enforcing "the non-reliance clauses to bar AES's fraud claims as a matter of law would be inconsistent with Section 29(a)," as it would be "an anticipatory waiver of potential future claims under Rule 10b-5."¹⁸⁹

However, this case does not extinguish the utility of non-reliance clauses. In remanding, the court noted that, "non-reliance clauses are, of course, among the circumstances to be considered in determining the reasonableness of any reliance."¹⁹⁰ More specifically, "a buyer in a non-reliance clause case will have to show more to justify its reliance than would a buyer in the absence of such a contractual provision."¹⁹¹ Consequently, "cases involving a non-reliance clause in a negotiated contract between sophisticated parties will often be appropriate candidates for resolution at the summary judgment stage."¹⁹²

Either court's analysis of non-reliance clauses bodes favorably for the utility of big boy letters.¹⁹³ Under the *Harsco* analysis, big boy letters limit claims by ruling out those that arise out of the nondisclosure.¹⁹⁴ The big boy letter, therefore, defines the boundaries of the transaction for the parties, and allows them to proceed on the common ground that disclosure of the nonpublic information will not occur. The signatory, too, attests that it will not receive any of the nonpublic information, and represents that it will not rely on the nondisclosure.¹⁹⁵ As such, the signatory cannot possibly be said to have reasonably relied on the nondisclosure. Even under the *AES* approach, if a big boy letter does not dissolve a case at the summary

184 343 F.3d 189 (2d Cir. 2003).

185 325 F.3d 174 (3d Cir. 2003).

186 *See id.* at 177.

187 *See id.* at 177–78.

188 *Id.*

189 *Id.* at 180.

190 *Id.* at 181.

191 *Id.*

192 *Id.*

193 However, given that the Second Circuit seems more embracing of non-reliance clauses, it would be wise for practitioners to draft big boy letters with a New York choice of law provision, rather than submit to the laws of Delaware, so that in the event of a dispute, a court within the Second Circuit will hear the case.

194 *See supra* notes 178–83 and accompanying text.

195 *See supra* note 13 and accompanying text.

judgment stage, at the very least it raises the bar for a plaintiff attempting to prove reasonable reliance.¹⁹⁶

IV

BIG BOY LETTERS AND THE SEC

To date, the SEC has yet to take an official position on the status of big boy letters.¹⁹⁷ In recent months, however, four SEC officials have commented on the practice.¹⁹⁸ These remarks, taken together with the SEC's allegations in *SEC v. Barclays Bank PLC*,¹⁹⁹ provide insight into the SEC's stance on big boy letters. In fact, they seem to presage the SEC's strategy regarding such agreements.

According to an associate regional director at the SEC, the SEC regards possible abuse of big boy letters as a "significant area of concern"²⁰⁰ and mentioned that "the issue is getting a lot of attention."²⁰¹ In November 2007, an associate director in the SEC Division of Enforcement bluntly stated that big boy letters would not provide any defense to an SEC charge of insider trading.²⁰² Several days prior, an associate director in the SEC Division of Investment Management cautioned that "the SEC could be in a position to sue" over big boy letters.²⁰³ To do so, the SEC "would just need to show that someone was deceived."²⁰⁴ That "someone" does not have to be the signatory to the big boy letter, another associate regional director explained.²⁰⁵

These comments all lead to one place—the misappropriation theory of insider trading. Recall that the Supreme Court adopted the misappropriation theory in the seminal case of *United States v. O'Hagan*.²⁰⁶ O'Hagan was a partner at a law firm in Minneapolis, Minnesota.²⁰⁷ In 1988, Grand Metropolitan PLC (Grand Met) retained his firm in connection with a potential tender offer for Pillsbury's common stock.²⁰⁸ While O'Hagan himself did not work on Grand Met's takeover effort, he learned of Grand Met's plans and purchased call options in the target company prior to the announcement of the tender offer.²⁰⁹ An SEC investigation concluded with a fifty-seven

196 See *supra* notes 190–91 and accompanying text.

197 See *supra* note 30 and accompanying text.

198 See *supra* note 30 and accompanying text.

199 No. 07-CV-04427 (S.D.N.Y. May 30, 2007).

200 Stoffregen, *supra* note 12 (quoting Thomas Biolsi).

201 *Id.*

202 See McTague, *Not a Defense*, *supra* note 30, at 1832.

203 Stoffregen, *supra* note 12 (quoting Doug Scheidt).

204 *Id.*

205 See McTague, *In Insider Case*, *supra* note 13, at 1893.

206 521 U.S. 642 (1997); see also text accompanying *supra* notes 49–56.

207 *Id.* at 647.

208 See *id.*

209 See *id.* at 647–48.

count indictment against O'Hagan, seventeen of which alleged violations of Rule 10b-5.²¹⁰

O'Hagan's conduct, however unethical, lies outside the reach of the classical theory of insider trading, since O'Hagan was not an insider of the target company whose shares he traded.²¹¹ As such, there was a need to reshape the theory supporting liability under Rule 10b-5. The misappropriation theory holds that a trader violates section 10(b) and Rule 10b-5 "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."²¹² Justice Ginsburg, writing for the majority, maintained that:

Under [the misappropriation] theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.²¹³

Thus, the trader owes a duty to the source of the nonpublic information, and not to the trading counterparty.²¹⁴ As such, the trader perpetrates a fraud on the source of the information.²¹⁵

When it comes to big boy letters, the SEC focuses on just this—a fraud on the source of the information. In truth, this is the only way that the SEC *can* interrupt trades involving big boy letters²¹⁶ since, in most instances, the classical theory will be inapplicable. A look at the complaint in *SEC v. Barclays Bank PLC*²¹⁷ reveals that the charges "were brought squarely under the misappropriation doctrine."²¹⁸

²¹⁰ *Id.* at 648.

²¹¹ *Id.* at 653 n.5 ("The Government could not have prosecuted O'Hagan under the classical theory, for O'Hagan was not an 'insider' of Pillsbury, the corporation in whose stock he traded.").

²¹² *Id.* at 652.

²¹³ *Id.* at 652.

²¹⁴ *See id.* at 652–53; *see also id.* at 690 n.6 (Thomas, J., concurring in part and dissenting in part) ("The dishonesty in misappropriation is in the relationship between the fiduciary and the principal, not in any relationship between the misappropriator and the market.").

²¹⁵ *See id.* at 656 (majority opinion) ("[T]he person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.").

²¹⁶ *See* Bodner et al., *supra* note 11, at 9 n.4 ("Assuming that a trade would otherwise fit within the rubric of the misappropriation theory . . . reliance on a big boy letter is highly questionable.").

²¹⁷ No. 07-CV-04427 (S.D.N.Y. May 30, 2007).

²¹⁸ *Revisiting Insider Trading*, *supra* note 9, at 23; *see, e.g.*, Complaint ¶ 17, *Barclays Bank*, No. 07-CV-04427, available at <http://www.sec.gov/litigation/complaints/2007/comp20132>.

This explains why the SEC “is taking a close look at the potential misappropriation of inside information covered by big boy letters.”²¹⁹

If a party misappropriates material, nonpublic information, the ensuing use of a big boy letter will not mitigate that party’s liability.²²⁰ However, the party could avoid liability under the misappropriation theory without abstaining from trading; if the party discloses to the source of the nonpublic information its intent to trade on the basis of that information, the party “forecloses liability under the misappropriation theory.”²²¹ The Court explained that, “[b]ecause the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation.”²²² The term “brazen misappropriator” is sometimes applied to the person who discloses an intention to trade to the information source, as the trader audaciously declares an objective to misappropriate confidential, nonpublic information while escaping insider trading liability.²²³

To be sure, evading liability as a brazen misappropriator will be impractical, if not impossible. If an investment bank informs a corporate client of the bank’s intention to trade on nonpublic information pertaining to the client, the bank knows that the corporation will not be a client of the bank much longer. Aside from the practical hurdles, there may be legal obstacles as well. In *SEC v. Rocklage*,²²⁴ the First Circuit made it quite nearly impossible to ever qualify as a brazen misappropriator.²²⁵ If future courts follow the *Rocklage* reasoning, it would eliminate the brazen misappropriator scenario altogether.

Still, the misappropriation theory is not new; Rule 10b-5 liability for misappropriating nonpublic information existed before big boy letters. Indeed, it was the *O’Hagan* decision that precipitated the use of big boy letters in the first place.²²⁶ Nonetheless, big boy letters ne-

pdf. An associate regional director at the SEC explained this approach at a December 3, 2007 conference. See McTague, *In Insider Case*, *supra* note 13, at 1893.

²¹⁹ Stoffregen, *supra* note 12 (summarizing the statements of another regional director).

²²⁰ See *id.*

²²¹ See *United States v. O’Hagan*, 521 U.S. 642, 655 (1997).

²²² *Id.*

²²³ See, e.g., Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1633–34, 1634 n.205 (1999).

²²⁴ 470 F.3d 1 (1st Cir. 2006).

²²⁵ See STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 120 (2d ed. 2007) (“[The First Circuit’s] reading of *O’Hagan* likely guts the brazen misappropriator loophole.”).

²²⁶ See *supra* note 56 and accompanying text; see also Adair & Lawrence, *supra* note 32 (“[T]he seminal case for [the use of big boy letters] is *United States v. O’Hagan* . . .”); John D. Hogoboom et al., “Big Boy” Letters Raise Insider Trading Concerns In and Out of Bankruptcy,

gotiated between sophisticated parties with equal bargaining power should be judicially enforceable, absent misappropriation of nonpublic information. Where there is such misappropriation, big boy letters will not shield a defendant from liability in an SEC enforcement action.²²⁷ Upon this analysis, it becomes obvious that the threshold issue regarding big boy letters is fundamentally different in private suits than in SEC actions; in the former, the main issue is whether the agreement violates section 29(a), whereas in the latter, the question is whether there was any misappropriation of confidential information.

V

AREAS OF CONCERN AND POTENTIAL SOLUTIONS

Despite the great utility of big boy letters and their potential to eliminate liability in private suits, the practice does have shortcomings. Such faults are not fatal, however, and the implementation of certain rules or procedures can provide a viable remedy. This Part presents three areas of concern and then explores potential solutions.

A. Downstream Purchasers

Recall the hypothetical transaction between *Seller* and *Buyer*, first presented in Part III. In that transaction, since *Seller* requested that *Buyer* sign a big boy letter, *Buyer* received a potent signal as to the qualitative nature of *Seller's* inside information and correctly presumed that the information was adverse to *Seller*. Suppose that *Buyer* nonetheless signs a big boy letter and takes ownership of the securities. After a change of heart, however, *Buyer* decides that it no longer wants to own the securities. Must *Buyer* disclose to downstream purchasers that it signed a big boy letter when it acquired the securities?

This was the very issue in *R² Investments LDC v. Salomon Smith Barney*,²²⁸ outlined in the Introduction. In that case, Smith Barney (at the time operating as Salomon Smith Barney) sold over \$20 million worth of bonds to Jeffries & Company using a big boy letter.²²⁹ Hours later, Jeffries resold those bonds to R². R² sued, alleging that Jeffries failed to make at least two necessary disclosures: that Jeffries signed a big boy letter when it bought the bonds from Smith Barney, and that

LOWENSTEIN SANDLER PC CLIENT ALERT (Lowenstein Sandler PC, Roseland, NJ), June 2007, available at <http://www.lowenstein.com/publications/articles/> (search "Publications Search" for "big boy") ("Big boy letters, as a means of avoiding insider trading liability, springs from the United States Supreme Court's recognition of the misappropriation theory of insider trading in its landmark ruling in *United States v. O'Hagan*.").

²²⁷ See *supra* notes 215–19 and accompanying text.

²²⁸ No. 01-CV-03598 (S.D.N.Y. Apr. 27, 2001).

²²⁹ See Anderson, *supra* note 14.

Smith Barney traded the bonds while possessing material, nonpublic information.²³⁰

The concern here is simple to understand—big boy letters work in great part because of the quasi-disclosure they provide.²³¹ If the intermediary fails to tell a downstream purchaser of the existence of a big boy letter further up the chain, the quasi-disclosure does not occur and the necessary signal does not transmit.

One can easily envision a scenario where two parties collude to perpetuate a fraud on an unwitting third party by using big boy letters. Suppose that in the R^2 case, Smith Barney and Jeffries devised a plot to “launder” the inside information, using Jeffries as the intermediary. The unfortunate downstream purchaser, in this case R^2 , could face a predicament: it is not in privity with the initial seller, Smith Barney, and the intermediary technically lacks any material, nonpublic information, since it signed a big boy letter.²³² If the securities laws allowed such a scenario, then indeed “a giant loophole exists that essentially makes the insider trading laws meaningless.”²³³

There are potential solutions to this problem. The initial seller could draft a provision in the big boy letter that requires the downstream purchaser to execute its own big boy letter if it decides to resell the securities.²³⁴ Regardless, the intermediary would most likely demand a big boy letter²³⁵ to protect itself as the new seller in the string of transactions.²³⁶ However, including such a provision in the big boy letter provides the initial seller with some comfort that it will not be pulled into litigation should the intermediary fail to disclose the existence of a big boy letter to a downstream purchaser.

Another potential solution is for the initial seller to include a lock-up agreement in the big boy letter.²³⁷ The lock-up agreement

²³⁰ See Bodner et al., *supra* note 11, at 4.

²³¹ See *supra* Part III.A.

²³² The intermediary, though, knows that it signed a big boy letter. This knowledge alone could constitute material, nonpublic information, depending on the circumstances.

²³³ Anderson, *supra* note 14 (quoting a spokesperson for R^2 Investments). Of course, the existence of a big boy letter is itself material, nonpublic information, and the intermediary violates Rule 10b-5 by not disclosing it to the downstream purchaser.

²³⁴ See Adair & Lawrence, *supra* note 32.

²³⁵ The main reason an intermediary would not execute a big boy letter is because it could command a higher price for the securities without one. See *supra* note 108 and accompanying text.

²³⁶ See Anderson, *supra* note 14 (“If I am the buyer and I want to resell, it would be prudent for the new seller to enter into a big-boy letter. You are protecting yourself to the new buyer in the chain.” (quoting Howard Seife, the head of the bankruptcy practice at Chadbourne & Park)).

²³⁷ See *id.* A lock-up agreement is contractual assurance, usually obtained by underwriters in an initial public offering, that prohibits certain parties from selling any shares for a specified period. While the terms vary, lock-up agreements typically last for 180 days. See Securities and Exchange Commission, Initial Public Offerings, Lockup Agreements, <http://www.sec.gov/answers/lockup.htm> (last visited Sept. 8, 2008).

would prevent the downstream purchaser from reselling the securities for a limited time. The idea is that, while the securities are locked-up, the nonpublic information will become public, allowing the purchaser to trade the securities free of any restrictions. This alternative is less attractive than the first, though. A party that agrees to such a lock-up will demand a higher risk premium for taking possession of illiquid and tainted securities. At least under the first approach, the signatory can resell the securities, provided it executes a big boy letter with the next downstream purchaser.

The final possibility would be to enact a rule that compels the intermediary to pass along that vital piece of information—that it signed a big boy letter to purchase the securities. It is worth considering how much disclosure to mandate. Should the intermediary have to name the party it transacted with? This seems only fair, as it places the downstream purchaser in the same position as the intermediary at the time when the latter was judging its potential purchase. Should the intermediary disclose the number of times the underlying securities have changed hands in a big boy transaction and identify all upstream parties? This, too, is significant, as the signal gets noisier with each downstream transaction. Each of these bits of information provides the downstream purchaser with additional knowledge that it can use to infer the nature of the material, nonpublic information, thereby continuing the chain of necessary quasi-disclosures. The downstream purchaser does not receive all this information when it merely signs a big boy letter. Therefore, this approach is superior to either of the previous potential solutions because the buyer receives information of greater value without any added transaction costs,²³⁸ without the intermediary violating any contractual duties, and without the burden of a lock-up agreement.

Even considering these potential solutions, there are still lingering issues. For instance, at what point does the new seller in a chain of transactions *not* have to disclose the existence of a big boy letter to resell the securities? Imagine a chain of securities trades whereby *A* sells to *B*, who sells to *C*, who sells to *D*, who sells to *E*, and so forth. Under the third solution outlined above, each new seller would have to disclose the existence of all the big boy transactions up the chain—and the parties involved—with each new downstream purchaser. At some point, however, the material, nonpublic information will have become public, obviating the need to continue this string of disclosures. Yet, since the initial seller is the only one with the nonpublic information, only the initial seller will know when that information has become public, and downstream parties will continue to abide by

²³⁸ The transaction costs may, in fact, be lower, as the parties no longer need to draft and negotiate a big boy letter.

this compulsory disclosure rule. Perhaps a bright line rule that establishes that a downstream seller no longer needs to make disclosures once the public issuer files its next quarterly statement would avert this dilemma.

The most acute challenge, however, does not arise in face-to-face exchanges, such as those contemplated by this Note or involved in the *R²* case. A more serious challenge materializes when a big boy signatory unloads the toxic securities into the public markets through impersonal transactions. Indeed, it would be very difficult to trace the subsequent sale back to the initial seller. Transactions on impersonal markets, however, are beyond the scope of this Note.

B. Indirect Tipping Effect

The issue of an indirect tipping effect arises out of a big boy letter's most essential elements—the quasi-disclosure it provides and its signaling effect. As previously discussed, big boy letters provide a strong signal as to the nature of the nonpublic information. Building upon the hypothetical transaction depicted in Part III, assume that *Buyer*, upon being told that it must sign a big boy letter to consummate the sale, walks away from the bargaining table. But *Buyer* does not leave the negotiations empty-handed, as *Buyer* now realizes that there is adverse, material, nonpublic information relating to the underlying security. Theoretically, *Buyer* can then enter the marketplace and purchase put options, or otherwise short sell, the underlying security. The quasi-disclosure of a big boy letter, therefore, indirectly tips off any potential big boy signatory. Interestingly, such tipping may trigger tipper/tippee liability, under an expansive formulation of the rule established by the Supreme Court in *Dirks v. SEC*.²³⁹

This issue of an indirect tipping effect is simply a variation of the downstream purchaser issue. In both cases, a party takes advantage of the quasi-disclosure provided by big boy letters and converts it for

²³⁹ 463 U.S. 646 (1983). The tipper is the corporate insider who forwards the nonpublic information, and the tippee is the outside party who receives that information. *See id.* at 655–56.

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

Id. at 660. The test for determining tipper liability is “whether the insider personally will benefit, directly or indirectly, from his disclosure.” *Id.* at 662. The tippee’s liability depends on the tipper’s motivations. “Absent some personal gain, there has been no breach of duty to stockholders,” and “absent a breach by the insider, there is no derivative breach” by the tippee. *Id.* The *Dirks* test creates an asymmetry: if a tippee violates Rule 10b-5, so does the tipper, yet a tipper alone can violate the rule. *See id.*; *see also* 3 HAZEN, *supra* note 92, § 12.17[5] (describing the broad scope of tipper/tippee liability and how it is not constrained to cases of true insiders).

their own personal gain. And in both cases, the best solution is the same: force the party who received the quasi-disclosure to transfer that information to any future counterparties. In the context of big boy letters, the traditional “disclose or abstain” rule must morph into a “disclose the quasi-disclosure or abstain” rule. This rule would ensure that the signaling effect of big boy letters carries on during the stream of transactions, as the efficacy of such agreements is pinned to the quasi-disclosure they provide.

C. Overuse of Big Boy Letters

The overuse of big boy letters is a distant danger of limited scope. Suppose that, over time, practitioners find that big boy letters do indeed protect their clients from liability when trading on the basis on material, nonpublic information. Some practitioners, then, may insist on obtaining big boy letters for their clients as a matter of routine—either because they are unsure if their client has material, nonpublic information or simply because they are risk-averse. Initially, this may not seem like a realistic concern, given that the party demanding a big boy letter must lower its asking price. To that party though, a lower price could very well be worth eliminating insider trading liability and the corresponding reputational harm.

The issue with overusing big boy letters is that, at a certain point, big boy letters begin to lose their signaling feature. If big boy letters become customary in securities transactions, signatories will become inure to the quasi-disclosures they provide and discount them altogether. Once the signaling effect of a big boy letter is removed—either when a seller does not transmit it to a downstream purchaser or, as in this case, when a downstream purchaser ignores it—the utility of a big boy letter evaporates. *Seller*, now, may encounter liability, since the quasi-disclosure never occurs. Furthermore, if big boy letters become a mere formality, it would undermine *Seller's* argument that reasonable reliance on the nondisclosure is lacking.

Once market participants begin to realize the proliferation of big boy letters in securities transactions, a rational response by the signatory would be to ask for a representation in the big boy letter concerning the counterparty's possession of material, nonpublic information. Thus, the signatory to a big boy letter can confirm whether the counterparty is actually withholding information. The inclusion of such a representation makes concerns regarding the overuse of big boy letters somewhat of an academic exercise and thus, the harm is limited in scope.

CONCLUSION

Big boy letters can be an effective tool in enhancing market liquidity, but the SEC is justified in showing concern. Its concern, however, should not fixate on the welfare of the sophisticated signatory who voluntarily engages in the transaction. Instead, the SEC should concentrate on the aftermath of the trade, particularly the signatory's ultimate disposition of those securities. Downstream is where the SEC should focus its interest, because that is where the public is at risk of unknowingly purchasing toxic securities. The role of the SEC is not to regulate the substance of a trade or to prevent bad or risky investments. In this instance, the calculated judgments of sophisticated parties bargaining at arm's length and with ready access to counsel ought to be left alone.