"Big Boy" Letters and the Enforcement Implications of SEC v. Barclays

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Last week, the U.S. Securities and Exchange Commission ("SEC") announced a settled enforcement action against Barclays Bank PLC and a former Barclays trader for purported insider trading violations. *See* http://www.sec.gov/litigation/litreleases/2007/lr20132.htm. The SEC's complaint alleges that the Barclays trader participated on various creditors' committees of bankrupt corporations, thereby becoming privy to material non-public information, including recent business plans, detailed management projections, and proposed plans of reorganization. At the same time, he also acted as the head proprietary trader for the Barclays U.S. distressed debt desk and used his inside information to buy and sell corporate securities in the bankrupt companies. In a few instances, the Barclays trader notified his trading counterparties that Barclays "may have" inside information and asked them to sign letters acknowledging as much, though no further details were ever disclosed. According to the SEC, Barclays took unfair advantage of this information disparity to reap ill-gotten gains amounting to nearly $4 million.

While, in some ways, the *Barclays* case presents a straightforward tale of insider trading, it also highlights two less well-known topics that have not previously been the subject of much regulatory scrutiny: (1) the participation by financial institutions on creditors' committees, where inside information about the debtor is often shared, and (2) the use of non-reliance (or so-called "Big Boy") letters to trade while in possession of material non-public information.

As a general rule, it is not uncommon for financial institutions to act as commercial lenders to corporations and, at the same time, to trade in their securities. When acting in a lending capacity, those financial institutions often become exposed to material non-public information about a borrower. This is especially true in distressed situations, where lenders who participate on a creditors' committee are routinely provided with inside information about the debtor's financial condition and operations. Indeed, the Bankruptcy Code expressly provides for creditors' committees to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor." 11 U.S.C. § 1103. Because the lender typically obtains its information through an express or implied promise of confidentiality, the rules governing insider trading will apply to restrict the lender's ability to buy or sell the debtor's securities.

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One traditional solution for many financial institutions has been to impose an information barrier (or so-called "firewall") to separate those individuals who serve on creditors' committees from those who engage in securities trading. The purpose of an information barrier is to prevent the traders from being tainted by any inside information. Furthermore, for those individuals who have already been exposed to material non-public information, the application of "watch lists" or "restricted lists" can serve to prevent them from engaging in any unlawful transactions. Where an information barrier or other protocols are shown to be effective, as the SEC has recognized, they will serve as a valid defense to a claim of insider trading. *See* Rule 10b5-1(c)(2). The *Barclays* case seems to be an example, however, where the compliance department failed to impose information barriers or otherwise enforce its policies and procedures to prevent the misuse of material non-public information.

The *Barclays* case also touches on another potential response to the legal restrictions associated with possessing inside information, namely, requesting one's trading counterparty to execute a non-reliance or "Big Boy" letter. Although the exact language used in a "Big Boy" letter may vary, the basic concept involves a representation by the signing counterparty that it is financially sophisticated and acknowledges that the insider has or may have material non-public information to which the signatory is not privy. The counterparty represents that it nonetheless wishes to proceed with the transaction – *i.e.*, "I'm a big boy" – and (1) provides a blanket waiver of any potential claims under the securities laws, or (2) waives any factual assertion of detrimental reliance on the non-disclosure, or both. Thus, a "Big Boy" letter would seem to provide some legal comfort to the insider in the event that private litigation later ensues where the aggrieved counterparty alleges fraud.

The enforceability of a "Big Boy" letter, however, is hardly free from doubt. In a case where the counterparty has signed a blanket waiver of all legal claims, such a waiver might be deemed invalid under Section 29(a) of the Securities Exchange Act of 1934. That provision reads: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of [the Exchange Act] or of any rule or regulation thereunder . . . shall be void." *See* 15 U.S.C. § 78cc(a). In other words, Section 29(a) prohibits the parties, as a matter of public policy, from opting out of the federal securities laws or contracting around them. *See AES Corp. v. Dow Chemical Co.*, 325 F.3d 174, 181 (3d Cir. 2003).

Somewhat more encouraging is the argument that the insider's "quasi-disclosure" that he has or may have material non-public information, coupled with the waiver of detrimental reliance, shows that, as a factual matter, the signatory had no reasonable expectation of information parity. Since reliance by the plaintiff and a deceptive act or omission by the defendant are both essential components of a private cause of action under Rule 10b-5, *see Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988), the existence of a "Big Boy" letter would mean that the plaintiff could not establish those elements (or, at least, would be hard-pressed to

do so) at trial. This argument finds some support in the decisions of the Third, Ninth, and Tenth Circuits.

In *AES*, the Third Circuit focused on the element of "reasonable reliance" and held that non-reliance language contained in a merger agreement should be considered substantial evidence on that point and would, in some cases, justify summary judgment. 325 F.3d at 181. In *McCormick v. Fund American Companies, Inc.*, 26 F.3d 869, 879-80 (9th Cir. 1994), and *Jensen v. Kimble*, 1 F.3d 1073, 1078 (10th Cir. 1993), the Ninth and Tenth Circuits took a different approach and evaluated whether the alleged misconduct was even "manipulative or deceptive" in the first place. In both instances, the Court of Appeals assumed that there was a fiduciary duty to disclose, but held that, since the non-disclosing party had explicitly informed the other of its failure to do so, those omissions could not be considered manipulative or deceptive. As the Court in *McCormick* summarized, "since the plaintiff 'knew what he didn't know,' there was nothing misleading in the omission." 26 F.3d at 880.[1]

Even under *AES*, *McCormick*, and *Jensen*, however, the insider and the "Big Boy" signatory still run the risk together of being sued by some third party who has engaged in a downstream transaction with the signatory. Take, for example, the situation where an insider sells securities to a buyer pursuant to a "Big Boy" letter, and the buyer then resells those securities to a third party unawares. If the material non-public information is later disclosed and those securities plummet in value, the aggrieved third party could claim that it was victimized by both the insider and the "Big Boy" signatory – that the "Big Boy" letter was simply a sham designed to "launder" the inside information and permit the unloading of over-valued securities on an unwitting public. Even if those allegations were unfounded, to avoid needless litigation, the insider might wish to insist that a "Big Boy" signatory refrain from engaging in any further downstream transactions for a period of time or, otherwise, require it to include the "Big Boy" letter as an accompanying document to any further trades.

Lastly, as the *Barclays* case demonstrates, while a "Big Boy" letter could provide some defenses in private litigation, its usefulness might be significantly curtailed in the context of a government enforcement action. Since the development of insider trading law in the 1960s, the standard rule declared by the SEC and adopted by the courts has consistently been that "a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him." *Chiarella v. United States*, 445 U.S.

[1] Both *McCormick* and *Jensen* involved allegations that the insider had breached his fiduciary duties to the plaintiff-counterparty. As discussed below, the legal analysis might be different in the context of a "misappropriation" case, where the insider is alleged to have breached his duty of trust or confidence to some third party not involved in the securities trade. *See* 15 U.S.C. § 78t-1(a) (granting private right of action to "contemporaneous traders" for claims based on "misappropriation" theory). In those cases, where a private plaintiff brings suit, the argument under *AES* that a "Big Boy" letter precludes a finding of reliance may prove to be more effective.

222, 227 (1980) (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)); *see also SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968 (*en banc*). Measured against this "disclose or abstain" rule, it is unclear whether trading with a "Big Boy" letter would pass muster. In cases brought by the SEC under a "classical" theory of insider trading, where the insider owes a fiduciary duty directly to his trading counterparty, it may be possible to argue, under *McCormick* and *Jensen*, that the acknowledgments contained in a "Big Boy" letter are sufficient to satisfy the insider's disclosure obligations and, therefore, no deception has occurred.[2]

That argument might not carry the same weight, however, in a case where the SEC sues under a "misappropriation" theory. In those circumstances, the insider owes a duty of trust or confidence to the source of his inside information, and he breaches that duty when he deceptively misuses the information to engage in a self-interested securities transaction. *See United States v. O'Hagan*, 521 U.S. 642, 656 (1997) (stating that, under "misappropriation" theory, "the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information"). An example might be where the employee or agent of an acquiror buys shares in a target corporation before a planned takeover is announced. In that instance, the transaction represents a breach of the insider's duty to his employer – and a "Big Boy" letter signed by the trading counterparty would seem to do little to redress that breach.

The *Barclays* case involved dozens of insider trades, with only a handful using "Big Boy" letters. Thus, the SEC, while referencing the practice, did not express an opinion as to its legality. It remains to be seen whether the SEC will continue to pursue enforcement actions involving "Big Boy" letters and whether the courts will eventually be asked to resolve some of these complex questions.

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[2] More difficult in an enforcement proceeding is the reliance argument under *AES* since the SEC is not required to prove reliance. *See, e.g.*, *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993) (citing cases).

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