The Big Boy Dilemma

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In many ways, the SEC's action against Steve Landzberg, a bond trader at Barclays, was a typical insider trading case. The SEC alleged, and Mr. Landzberg consented to judgment without admitting or denying the SEC's allegations, that he traded distressed bonds while in possession of material nonpublic information received while a member of six creditors committees.

The case is nonetheless sending tremors through the securities bar. Some of the purchasers that Mr. Landzberg allegedly defrauded signed "big boy letters."

In a big boy letter, a purchaser acknowledges that the seller has inside information that will not be disclosed, but states that it will nonetheless buy the security at the price offered, waiving any legal claims based on the information disparity. Big boy letters are not used to make retail sales; the name derives from the fact that these are trades among sophisticated institutional investors. Big boy letters are useful where, as in the Landzberg case, the seller has signed a confidentiality agreement with an issuer, but a willing institution wishes to purchase the securities without knowing the information that is blocked from disclosure by the agreement.

The disclosure of possible inside information in a big boy letter is intended to eliminate the reliance requirement that is essential to a Rule 10b-5 violation. When a purchaser is warned that the seller has inside information, and is sophisticated enough to understand the warning, it is difficult to argue that the purchaser relied on the information and was thus deceived by it. Nonetheless, the SEC appears to be taking the view that a big boy letter is not sufficient to overcome a 10b-5 violation.

In recent conferences, SEC staff members have suggested that their approach to big boy letters is based on a misappropriation theory. The idea would be that the seller, having agreed to keep the information confidential, would be misappropriating the information from the source of the information. And, it is true that the courts have held that, to find liability for insider trading, there must be proof that the trader had an obligation to someone not to misuse, and hence "misappropriated," the information. However, this does not mean that misappropriation, by itself, is a violation of federal securities laws. Rule 10b-5 prohibits deception, not misappropriation.

The difficulty is that the information a seller has might not mean much to the buyer. The buyer of a 1929 Dusenberg probably doesn't care about the seller's knowledge that the odometer reads incorrectly. The purchase is based on other factors.

Similarly, if the material nonpublic information known by the seller doesn’t make any difference to the buyer, what useful purpose is served by preventing the trade?