CORPORATIONS

THE FIRST AMENDMENT AND THE SECURITIES LAWS

The following white paper is a product of the Federalist Society's SEC & First Amendment Working Group. The working group seeks to raise the public's awareness of the First Amendment implications of SEC regulatory activity and will also sponsor a summit addressing these issues later this year.

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A PREFATORY NOTE ON ENRON

As this Working Group was finishing its white paper on the securities laws and the First Amendment, Enron Corporation went into bankruptcy. Enron's filing was followed by a swirl of accusations and counter-accusations about who was to blame for this latest financial fiasco, and a host of congressional hearings, private lawsuits, and administrative proclamations about the need for reform of the securities laws and regulations. Given the ongoing ado, it seems appropriate to offer at least a brief comment on the relevance of the Enron matter to the topic under discussion.

In the accompanying white paper, the Working Group raises questions about the First Amendment implications of restrictions and compulsions of speech imposed by the securities laws. Because some of the accusations involving Enron concern the alleged failure to disclose – or active efforts to conceal – material information about the financial condition of Enron, there is certainly some interplay between current events and SEC rules either compelling or restricting the disclosure of information about publicly traded companies and their activities.

While the charges being leveled against Enron and various affiliated persons and entities provide an interesting context in which to consider the First Amendment issues raised in this white paper, they do not alter the fundamental constitutional questions raised by SEC restrictions on and compulsions of speech. Indeed, if anything, current efforts to use this latest scandal as an occasion to enact new controls on corporate conduct make it even more important to pay close attention to basic First Amendment constraints on government power over speech. For example, we have already seen a Congressional committee and the SEC encourage the self-regulatory organizations to propose rules that would impose "blackout periods" on securities analysts and even dictate the classification of their recommendations.

The First Amendment, like many constitutional restrictions on government authority, exists precisely to check the overly zealous exercise of government authority in the heat of current passions. The understandable urge to act against an immediate perceived problem must be tempered by the faithful application of long-standing constitutional principles to any proposed solution to such problem. Careful consideration of the First Amendment principles articulated in this white paper, and to the various questions posed concerning existing regulations, will help to ensure that any future regulations arising out of the Enron situation will preserve the long-term value of freedom of speech for investors and business persons alike as well as remedy any potentially problematic accounting and business practices that may have been highlighted by Enron's unexpected demise.

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Virtually all forms of government regulation of speech are limited, to one degree or another, by the prohibition on the abridgment of free speech contained in the First Amendment. The Supreme Court has found First Amendment limitations applicable to restrictions on speech, compulsions of speech, compelled disclosure of the identity of speakers, and the conditioning of government benefits or burdens on such regulations of speech. And, in recent years, the Supreme Court has steadily increased its scrutiny of restrictions on commercial speech.

But one government agency that routinely regulates speech – the Securities and Exchange Commission – has avoided significant First Amendment scrutiny of its conduct and regulations. While the SEC regulates speech in the context of statements by publicly-traded companies, shareholder proposals, private placements, public offerings, tender offers, and even state and local campaign contributions, such regulations have received little First Amendment review in the courts.

The Federalist Society has formed a working group of experts to study some of the basic First Amendment principles governing the regulation of speech and some of the SEC's regulations affecting speech. This white paper, which is the group's first work product, surveys the securities area, and presents questions concerning the applicability of the First Amendment to the SEC's regulations. The Society hopes that this paper and some subsequent programs will spark debate about these important issues.

I. First Amendment Basics

The First Amendment to the U.S. Constitution generally places strict limits on government attempts to regulate speech. "Where a government restricts the speech of a private person, the state action may be sustained only if the government can show that the regulation is a precisely drawn means of serving a compelling state interest." *Consolidated Edison Co.* v. *Public Service Comm'n of New York*, 447 U.S. 530, 540 (1980).

The First Amendment's protection against government restrictions on speech has several corollaries. First, just as the government generally may not prohibit speech, it likewise may not compel speech. A seminal case on compelled speech is *West Virginia Board of Education* v. *Barnette*, 319 U.S. 624 (1943), in which the Supreme Court struck down the compulsory recitation of the pledge of allegiance. As Justice Murphy's often-quoted concurrence explained, "[t]he right of freedom of thought and of religion as guaranteed by the Constitution against State action includes both the right to speak freely and the right to refrain from speaking at all." 319 U. S. at 645. Likewise "[f]or corporations as for individuals, the choice to speak includes within it the choice of what not to say." *Pacific Gas & Elec. Co.* v. *Public Utilities Comm'n of California*, 475 U.S. 1, 16 (1986). The First Amendment's protections against compelled speech also extend to speech deemed merely informational rather than ideological. For example, in *Riley* v. *National Federation of Blind of North Carolina, Inc.*, 487 U.S. 781 (1988), the Court struck down a requirement that professional fundraisers disclose to potential contributors the percentage of previous contributions retained by the fundraiser rather than sent to the charity. In doing so, the Court stated that "[t]here is certainly some difference between compelled speech and compelled silence, but in the context of protected speech, the difference is without constitutional significance, for the First Amendment guarantees 'freedom of speech,' a term necessarily comprising the decision of both what to say and what not to say." *Id*. at 796-797.

Second, the First Amendment's protection against the restriction or compulsion of speech is reflected in the constitutional protection for anonymous speech. Forcing a speaker to reveal his or her identity has both elements of compulsion and restriction – they are compelled to say more than they would choose on their own, and they may be deterred from speaking at all if, by revealing their identity, they may expose themselves to various forms of harassment or retaliation for their views. Because of such concerns, the Court has protected the right of individuals to remain anonymous when engaging in First Amendment activity. *See McIntyre* v. *Ohio Elections Comm'n*, 514 U.S. 334 (1995); *NAACP* v. *Alabama*, 376 U.S. 449 (1958).

Third, just as the government may not directly compel or restrict speech, it may not indirectly coerce speech or silence by conditioning valuable benefits on such behavior. *See, e.g., O'Hare Truck Service, Inc.* v. *City of Northlake,* 518 U. S. 712 (1996) (requirement of political support an unconstitutional condition on government contracting decision); *Elrod* v. *Burns*, 427 U.S. 347 (1976) (political affiliation inappropriate criterion for most public employment decisions); *Keyishian* v. *Board of Regents of Univ. of State of New York*, 385 U.S. 589 (1967) (government may not require an individual to relinquish rights guaranteed by the First Amendment as a condition of public employment).

While these principles are routinely applied in a variety of circumstances, they have generally not been given much application in the context of regulations by the Securities and Exchange Commission. The one case in which the Supreme Court has addressed the First Amendment in the securities context is *Lowe* v. *SEC*, 472 U.S. 181 (1985), where the Court relied on First Amendment concerns to drive a narrow construction of a publishing restriction contained in the Investment Advisers Act, 15 U.S.C. § 80b-1 *et seq*. In deciding whether the Act applied to a person who published an investment newsletter circulated for sale to the general public, the Court held that such a publisher was not covered, and hence not required to register under the Act in order to publish. 472 U.S. at 211. While nominally a decision based on statutory construction, the Court made clear that its view was driven by its concern – imputed to Congress – that the Act's requirements, as sought to be applied to a publisher of non-personal investment newsletters, would violate the First Amendment. 472 U.S. at 204-05, 210 nn. 57 & 58.

Justice White, joined by Chief Justice Burger and then-Justice Rehnquist, went even further, concurring in the result and resting that concurrence squarely on the First Amendment. While the concurring Justices would have interpreted the Act broadly to cover the publisher of the newsletter, they found that the Act's restriction on publishing such newsletters was unconstitutional. 472 U.S. at 211 (White, J., concurring). The concurrence stated that absent evidence the advice being given in the newsletters was fraudulent, deceptive, or manipulative, the Act's registration requirement (and suppression of unregistered publication) was "a direct restraint on freedom of speech and of the press subject to the searching scrutiny called for by the First Amendment." *Id*. at 233. In reaching this conclusion, Justice White acknowledged the government's argument that the restriction was merely on commercial speech and thus subject to less exacting scrutiny, and acknowledged as well the publisher's argument that the newsletters were not commercial speech because they did not propose a transaction between the speaker and his audience. *Id*. at 233-34. He did not resolve that dispute about the nature of the speech, however, because the restriction failed First Amendment scrutiny even under the more lenient standards for commercial speech restrictions set out in *Central Hudson Gas & Electric Corp*. v. *Public Service Commission of New York*, 447 U.S. 557 (1980). In particular, the concurring Justices found that even under the *Central Hudson* test, the drastic prohibition of barring all publication by unregistered persons could not be "justified by a mere possibility that the prohibited speech will be fraudulent." *Id*. at 235.

Despite the First Amendment analysis and concerns presented by the two opinions in *Lowe*, few securities laws and regulations have been subject to First Amendment scrutiny. Many such laws and regulations restrict or compel a wide variety of speech, and they frequently condition a range of legal benefits on the speech or silence of a particular company or other regulated entity. To the extent that such laws and regulations impact non-commercial speech, they likely would be subject to strict scrutiny. And even to the extent that such restrictions involve purely commercial speech – as defined in Supreme Court jurisprudence – they still would raise constitutional concerns, as the concurrence in *Lowe* amply demonstrates. Indeed, since *Lowe*, restrictions on commercial speech have been subjected to even greater scrutiny.

While for several decades during the mid-20th century commercial speech was excluded from First Amendment protection, *Valentine v. Chrestensen*, 316 U.S. 52, 54 (1942), the Supreme Court eventually recognized the value of, and protection for, even purely commercial speech in *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748 (1976). The reasons identified by the Court in *Virginia State Board* for protecting commercial speech echo its reasons for protecting political and other noncommercial speech:

> There is, of course, an alternative to this highly paternalistic approach [of allowing a government to keep its citizens in ignorance]. That alternative is to assume that this information is not in itself harmful, that people will perceive their own best interests if only they are well enough informed, and that the best means to that end is to open the channels of communication rather than to close them. . . . It is precisely this kind of choice, between the dangers of suppressing information, and the dangers of its misuse if it is freely available, that the First Amendment makes for us.

Id. at 770. The Court in *Virginia State Board* further explained that a "particular consumer's interest in the free flow of commercial information . . . may be as keen, if not keener by far, than his interest in the day's most urgent political debate." *Id.* at 763. The Court has likewise recognized that commercial speakers themselves have a cognizable First Amendment interest, writing that so long as the sale of a product is lawful, the industry producing and selling that product "has a protected interest in communicating information about its products and adult customers have an interest in receiving that information. *Lorillard Tobacco Co.* v. *Reilly*, — U.S. —, 121 S. Ct. 2404, 2430 (2001).

Since 1980, the analytical framework for reviewing restrictions on commercial speech has been provided by the *Central Hudson* test, applied with decisive effect in Justice White's *Lowe* concurrence. In its original formulation, that test contained the following four elements: (1) the communication is neither misleading nor related to unlawful activity, (2) the government must assert a substantial interest; (3) the restriction must directly advance the governmental interest involved; and (4) the restriction must be no more extensive than necessary. *Central Hudson*, 447 U.S. at 564.

Despite a brief dilution of that test in the Court's 1986 decision in *Posadas de Puerto Rico Associates v. Tourism Co. of Puerto Rico*, 478 U.S. 328 (1986), the Court has since retreated from *Posadas* and applied the *Central Hudson* test with vigor. For example, in *Edenfield v. Fane*, 507 U.S. 761, 771 (1993), the Court required the government under the third element of the *Central Hudson* test to "*demonstrate* that the harms it recites are *real* and that its restriction will *in fact* alleviate them to a *material* degree." (Emphasis added.) Other decisions have likewise rigorously applied *Central Hudson*'s third element. *See, e.g., Rubin v. Coors Brewing Co.*, 514 U.S. 476, 486-88 (1995); *Florida Bar v. Went for It, Inc.*, 515 U.S. 618, 626 (1995); *Ibanez v. Florida Dep't of Bus. & Prof'l Regulation*, 512 U.S. 136, 142-48 (1994).

The Supreme Court has similarly strengthened the fourth element of the *Central Hudson* test, holding that a restriction fails if there are "obvious less-burdensome alternatives to the restriction on commercial speech." *City of Cincinnati v. Discovery Network, Inc.*, 507 U.S. 410, 417 n.13 (1993). That clarification of the fourth element of the *Central Hudson* test has become a significant independent ground under which restrictions on commercial speech are invalidated. *See, e.g.*, *Rubin*, 514 U.S. at 490-91.

Other recent Supreme Court opinions have continued to emphasize the renewed stringency of the *Central Hudson* test and have confirmed the demise of the approach in *Posadas*. Thus, in *44 Liquormart, Inc. v. Rhode Island*, 517 U.S. 484 (1996), Justice Stevens, joined by Justices Kennedy, Thomas, and Ginsburg, flatly stated that "*Posadas* erroneously performed the First Amendment analysis" and concluded that government "does not have the broad discretion to suppress truthful, nonmisleading information for the paternalistic purposes that the *Posadas* majority was willing to tolerate." 517 U.S. at 509-10. And writing separately, Justice O'Connor, joined by Chief Justice Rehnquist (who authored *Posadas*) and two other Justices, concluded that:

> Since *Posadas*, however, this Court has examined more searchingly the State's professed goal, and the speech restriction put into place to further it, before accepting a State's claim that the speech restriction satisfies First Amendment scrutiny. . . . [W]e declined to accept at face value the proffered justification for the State's regulation . . . . The closer look that we have required since *Posadas* comports better with the purpose of the analysis set out in *Central Hudson*, by requiring the State to show that the speech restriction directly advances its interest and is narrowly tailored.

Id. at 531-32 (citations omitted).

Likewise, in *Greater New Orleans Broadcasting Ass'n v. United States*, 527 U.S. 173 (1999), the Court described the several opinions in *44 Liquormart* as "conclud[ing] that our precedent both preceding and following *Posadas* had applied the *Central Hudson* test more strictly." 527 U.S. at 182. And Justice Thomas, concurring in the judgment, would have gone farther and applied strict scrutiny rather than the *Central Hudson* test. *Id.* at 197.

The Supreme Court's most recent decisions have continued to apply *Central Hudson* to strike down restrictions on commercial speech. *See, e.g., Lorillard Tobacco Co.*, — U.S. at —, 121 S. Ct. at 2421. And those decisions have begun to recognize that even greater protection may be warranted for commercial speech. Thus, in *Greater New Orleans,* the majority acknowledged Justice Thomas's concurring views and raised the possibility that *Central Hudson* should be replaced with a "more stringent" test, recognizing that various legal thinkers, including "reasonable" judges, have adopted that position. *Id.* at 1930. And in *Lorillard Tobacco*, the Court responded to an argument in favor of strict scrutiny for commercial speech by recognizing that "several Members of the Court have expressed doubts about the *Central Hudson* analysis and whether it should apply in particular cases. — U.S. at —, 121 S. Ct at 2421. In both those cases, however, the restrictions at issue failed even the *Central Hudson* test, and thus the Court declined to decide whether a stricter First Amendment standard was required. However, in *United States* v. *United Foods*, *Inc*, — U.S. —, 121 S. Ct. 2334 (2001), the Court seemed to go a step further. The Court in *United Foods* again recognized the criticisms of *Central Hudson* but once again was able to strike down the compulsion even assuming some lesser protection of commercial speech. *Id.* at —, 121 S. Ct. at 2337-38. However, the union dues and state bar association cases it ultimately relied upon did not involve a differential standard for commercial speech and the Court never applied the *Central Hudson* test.

In light of general First Amendment principles regarding speech restrictions and compulsions, the increasingly vigorous protection being given to commercial speech, and the heretofore limited attention given to speech regulation in the securities context, now is a worthwhile time to examine a variety of securities regulations impacting potentially protected speech. Several such regulations are described, and constitutional questions are raised, in the following sections.

II. Regulation FD (Preventing "Selective Disclosure")

What the Rule Does. The SEC adopted Regulation FD in August 2000 after a comment period of nearly eight months. It requires covered companies to make a simultaneous public disclosure, by means of a report filed with the SEC or a broadly-disseminated press release, of any "material nonpublic information" that certain officers disclose to any of the following persons outside the company:

- broker-dealers, investment advisers, institutional money mangers and their employees (including analysts);
- investment companies and their affiliated persons; and
- any holder of the company's securities "under circumstances where it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information."

The reporting obligation is not triggered by a company's disclosures to persons who owe the company a duty of trust or confidence in respect of the information (*e.g.*, attorneys, investment bankers, or accountants), persons who expressly agree to an obligation of confidentiality and persons who receive the information in connection with a public offering registered with the SEC.[1]

The SEC proposed and adopted the rule against the background of criticism of securities analysts (particularly "sell-side" analysts, *i.e.*, analysts employed by broker-dealer firms). It was asserted by the then-chairman of the SEC and by the financial press that public companies regularly favored sell-side analysts with access to material nonpublic information and that these analysts used the information for the benefit of their large institutional clients. The SEC could not characterize such alleged favored access as securities fraud, given the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983), to the effect that a company officer's "tip" to an analyst was not fraudulent under Rule 10b-5 unless motivated by some pecuniary or reputational benefit accruing to the officer.

Since the rule became effective in October 2000, several surveys have examined whether companies are providing less information to analysts. While it is probably still too early to tell, the surveys suggest that Regulation FD may be having the "chilling effect" on companies that commenters on the proposed Regulation FD had predicted.

Why the SEC Adopted the Rule. The SEC justified the adoption of Regulation FD on the grounds that "the practice of selective disclosure leads to a loss of investor confidence in our capital markets." It anticipated benefits from Regulation FD similar to those produced by the regulation of insider trading. It also suggested that the rule would "reduce the potential for corporate management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors."

Alternatives. The SEC did not identify any alternatives in its release explaining the adoption of Regulation FD. The SEC noted the potential "chilling effect" of the rule on corporate disclosures to analysts, investors and the media, and the fact that commentators had suggested that the SEC was underestimating that effect. The SEC also noted that it had made modifications in the rule in response to such comments, including narrowing the group of persons from whom disclosures would trigger a Regulation FD obligation (as well as the group of persons *to* whom disclosure would trigger a Regulation FD obligation) and by reducing the regulatory and civil liability consequences of a Regulation FD violation. There is considerable current debate regarding the future of Regulation FD, including a recent SEC-sponsored "roundtable" and hearings before a House subcommittee. There have been a few calls for its repeal, but the most significant interest focuses on refining the definition of "materiality" for purposes of the rule, perhaps by means of a "safe harbor" that would define the level of materiality that would trigger a Regulation FD reporting obligation.

Questions Presented. What First Amendment standard should be applied to judge governmental conditions placed on the disclosure of material information about a company by certain company officials? Is all such information "commercial speech"? Does the characterization of the speech as commercial depend on whether the company is buying or selling its stock?

Is the required disclosure a form of compelled speech? Would the disclosures have to be attributed to a particular source, thus eliminating the possibility of anonymous leaks?

Assuming the government has at least a legitimate interest in bolstering investor confidence and providing equal access to information, is that interest nonetheless "substantial" for purposes of the First Amendment? Is the interest "compelling"? Does a public desire to have more information from an unwilling speaker constitute a valid interest at all? Does speech to a limited group of listeners receive diminished First Amendment protection because it does not necessarily reach a larger public audience?

Is there any evidence that the asserted problem with selective disclosures is in fact true? What evidence would be needed to establish the alleged problems for First Amendment purposes? What level of judicial review is appropriate when considering an administrative record purporting to establish harms from selective disclosure? Is the usual APA "arbitrary and capricious" standard of review sufficient, or does the First Amendment require more?

Does Regulation FD's discrimination among both speakers and recipients pose an independent First Amendment problem? What are the justifications for favoring the financial press with the ability to get selective disclosures, but not favoring other elements of the press or private recipients?

In light of the Supreme Court's determination in

Dirks that selective disclosure is not "fraudulent," should courts accept the government's characterization of such disclosures as abusive?

III. Rule 14a-8 (Shareholder Proposals in Proxy Statements)

What the Rule Does. Proxy statements are documents in which public companies solicit from their shareholders proxies for the election of directors and other action proposed to be taken at a special or annual meeting. The SEC's Rule 14a-8 requires a company to include in its proxy statement any proposal that is timely submitted by an eligible shareholder.[2] A shareholder proposal, including any accompanying supporting statement, may be as long as 500 words. The company must either identify the shareholder by name and address or state that it will provide this information on request. The company may include a statement opposing the shareholder proposal for any of the reasons set forth in the rule, but it must provide such a statement to the shareholder in advance of the meeting.

For purposes of the rule, a shareholder proposal is a recommendation or requirement that a company and/or its board of directors take action on a subject that is proper for shareholder action under the law of the state where the company is organized. Proposals that would bind the company often are excludable because they would interfere with the state-law duty of the board of directors to manage the company. However, the SEC takes the position that most proposals are proper under state law if they are cast as recommendations or requests that the board of directors take specified action.

The rule also permits a company to exclude a shareholder proposal on various grounds (including illegality, personal grievance, and special interest). One of the most important bases for exclusion of a proposal is that it deals with a matter relating to the company's "ordinary business operations." The application of this standard has been a subject of controversy for many years.

In 1992, the responsible division of the SEC announced in the *Cracker Barrel* "no-action letter" that it would consider a shareholder proposal concerning a company's employment policies and practices for its general workforce as relating to the company's ordinary business operations, notwithstanding that the proposal was tied to a "social issue" (*i.e.*, discrimination based on sexual orientation).[3] The letter stated that the SEC staff had found in recent years that the line between includable and excludable employment-related proposals was increasingly difficult to draw and that the distinctions that it had relied upon in the past had been criticized as "tenuous, without substance and effectively nullifying the application of the ordinary business exclusion to employment related proposals."

A few years later, however, the SEC reversed the *Cracker Barrel* policy and announced that the staff would return to its prior "case-by-case approach" to applying the ordinary business exclusion.[4] Proposals relating to ordinary business matters but focusing on "sufficiently significant social policy issues" would not be considered excludable because such proposals would "transcend . . . day-to-day business matters and raise policy issues so significant that [they] . . . would be appropriate for a shareholder vote." In making this determination, the SEC staff would "seek to use the most well-reasoned and consistent standards possible, given the complexity of the task." The staff also could be expected to "adjust its view" from time to time in the light of its experience dealing with proposals in specific subject areas and in the light of "changing societal views."

Shareholders have taken advantage of the more liberal SEC policy by submitting thousands of proposals involving a wide range of "social issues." Companies usually have been unsuccessful in persuading the SEC staff that the proposals should be excluded on the basis that they are directed at the company's ordinary business operations.

For example, the SEC staff recently refused to permit the largest U.S. gun manufacturer to exclude a religious order's proposal that the company provide shareholders with a comprehensive report on the company's policies and procedures "aimed at stemming the incidence of gun violence in the United States."

Why the SEC Adopted the Rule. Section 14(a) of the 1934 Act makes it illegal to solicit proxies in violation of such rules as the SEC may adopt as being necessary or appropriate in the public interest or for the protection of investors. The SEC adopted its first shareholder proposal rule in 1942 (proposals were limited under that rule to 100 words), and there does not appear to have been any direct challenge at any time to its authority to adopt such a rule. One appellate court has stated that Congress intended "to require fair opportunity for the operation of corporate suffrage" and that it "entertain[ed] no doubt that [the predecessor of the current rule] represents a proper exercise" of the SEC's rulemaking authority.[5]

The SEC has stated that Rule 14a-8 provides "a channel of communication among shareholders, and between shareholders and companies."[6] An authoritative treatise concluded, after a study of the rule's operations, that "[t]he very opportunity to submit proposals, even of an advisory nature, affords a safety valve for stockholder expression at a price to the [issuer] that would seem to be relatively slight. . . . [O]ne should not underestimate [the rule's] symbolic significance in an area in which no alternative philosophy has yet supplanted the classic theory of managerial responsibility to the owners of the business."[7]

Alternatives. The SEC has considered alternatives to the rule. These have included:

- withdrawing entirely from the field, leaving it to each state to adopt (or not) its own share holder proposal rule;
- adopting a supplemental rule to permit a com pany and its shareholders to adopt a plan pro viding their own alternative procedures govern ing the process and
- requiring companies to include in their proxy statement all proposals that are proper under state law and that do not involve the election of directors, subject to a numerical limit.

The SEC has concluded that most market participants prefer the current rule to any of the alternatives.

Questions Presented. Does the compelled circulation of the speech of a minority shareholder involve commercial speech? What if such speech revolves around social policy issues? Does the *ad hoc* nature of the SEC's "case-by-case" approach raise independent First Amendment problems? Does it create the risk of censorship? The risk of the government forcing inclusion of proposals that it favors?

Does the inclusion of such speech in company communications coerce a response from the company when it might otherwise prefer to remain silent? Does it imply agreement with the speech if the company remains silent?

How is the compelled inclusion of such speech different from requiring newspapers to provide free space for dissemination of readers' views on any topic whatsoever? How is it different from requiring utilities to include environmental material in their billing envelopes?

Does the fact that the speaker is a partial owner of the company alter the First Amendment analysis where the Board of Directors selected by the majority of shareholders disagrees with the speech? Could the company be forced to include minority shareholder speech in its communications to the general public?

Is there a First Amendment difference between requiring the inclusion of a proposal to be voted upon by shareholders and requiring inclusion of additional speech advocating that proposal? Is "ballot access" the same as speech, or is it conduct? Does the fact that most includable proposals must be non-binding mean that they are indeed pure speech and not conduct at all?

In the case of state-incorporated companies, what is the federal interest in compelling this type of internal communication among shareholders? Is corporate "suffrage" or "governance" a proper concern for the SEC where it does not bear upon the stability of the national securities market? Would the First Amendment analysis be any different if it were the States, rather than the SEC, that required inclusion of shareholder proposals?

What evidentiary support exists for the alleged government interest? What alternatives exist? Given current media of communication, do shareholders need access to such lists to communicate? Given current media of communication, is such communication less efficient or more costly to the speaker? Does the fact that the monetary cost to the company may be slight alter the First Amendment analysis?

IV. "General Solicitations" in Connection with Private Placements

What the Rule Does. Section 4(2) of the 1933 Act permits a company to offer and sell securities without registration with the SEC if the transaction does not "involv[e] any public offering." The SEC has elaborated on the statutory exemption for "private placements," most notably by adopting Regulation D. This set of rules provides relatively objective criteria for a company that wishes to sell securities in a private placement.

One of the general conditions for the availability of Regulation D, set forth in Rule 502(c), is that the securities not be offered or sold "by any form of general solicitation." The SEC understands a "general solicitation" to take place when an indefinite group of investors is made aware of an offering, whether or not the investors buy the security being offered or even have an opportunity – within the stated terms of the offer – to buy the security. Thus, the use of a non-password-protected Internet website to provide information about a private placement available only to a specified universe of sophisticated investors (*e.g.*, "qualified institutional buyers" or "accredited investors") runs the risk of violating the general solicitation prohibition even if not a single ineligible investor actually participates in the offering. Avoiding a general solicitation is important not only in the initial placement of securities in reliance on a private placement exemption but also in many secondary market transactions involving those securities. (Such transactions take place on a so-called "Section 4(1-1/2)" basis.)

The consequences of general solicitation are severe. The exemption for private placement can be lost, with the result that buyers of the security will have a one-year "put" of the security – no questions asked – back to the person from whom they bought it and all participants are subject to prosecution by the SEC for law violation.

Why the SEC Adopted the Rule. The SEC included the general solicitation prohibition in Regulation D and for many years resisted its elimination or dilution on the grounds that the statutory exemption referred to transactions not involving a "public *offering*" (emphasis added) and the perceived logical equivalence between "offering" and "general solicitation." The SEC's explanation lost much of its force in 1996 when Congress gave the SEC exemptive power in respect of private placements.

Notwithstanding its new exemptive authority, the SEC staff has continued to resist elimination or dilution of the prohibition on general solicitations. One possible (but unarticulated) explanation might be that securities sold in private placements become eligible to be sold in the public markets after two years. The SEC might be concerned that general solicitation during the two-year period might "condition the market" for the securities among members of the general public who might then acquire the securities when they become eligible for public trading. Another possible explanation is that negligence-based remedies such as those provided under Section 11 and Section 12(a)(2) of the 1933 Act are not available to purchasers of securities sold in private placements. Such investors, rather, are entitled to sue in the event of improper disclosure only under Rule 10b-5, a fraud-based remedy that requires proof of scienter and is otherwise subject to the limitations imposed by the Private Securities Litigation Reform Act of 1995. The SEC generally has been reluctant, possibly for this reason, to expand the availability of private placements.

Alternatives. Large-scale private placements often are conducted under Rule 144A, a rule adopted in 1990 that does not contain an express prohibition of a general solicitation since the securities can be offered and sold only to large "qualified institutional buyers." Still, the SEC staff has seized upon technical aspects of the rule to cast doubt on whether a Rule 144A transaction can really proceed if there has been a general solicitation.

The SEC has also proposed making the regulatory regime more attractive to execute public offerings on a registered basis and less attractive to make private placements. Obviously, concern about the general solicitation prohibition would disappear if the SEC were to succeed in making private placements unnecessary. On the other hand, issuers and agents would be exposed to the negligence-based remedies mentioned above.

An ABA group is proposing that the general solicitation prohibition be eliminated on condition that the privately-placed securities be sold only to eligible investors such as "qualified institutional buyers" or "accredited investors." An association of hedge funds (*i.e.*, private investment vehicles) has been reported as having made a similar proposal.

Questions Presented. While the solicitation of purchases of securities is commercial speech in connection with those being solicited, is it commercial speech as to those who are not being offered an opportunity to buy? Would a newspaper reporting on the details of a limited placement convert it into a general solicitation? Would the result vary depending on the source of the newspaper's information? Is such a distinction consonant with the First Amendment interest?

What is the harm of a "general solicitation" that can be accepted only by a limited class of sophisticated investors? Are sophisticated investors injured by the availability of information to others in the market? Does having more information, when they cannot purchase the securities being offered, injure unsophisticated investors?

Is the desire to deprive the general public of information out of concern for their inability to fully appreciate such information a valid government interest under the First Amendment? Does a concern over "conditioning the market" two years down the line justify suppression of information during the private placement period? Is there any evidence to demonstrate that such conditioning is harmful?

Is the exemption from the registration requirement a valuable benefit that is conditioned on the suppression of speech? Is it suppression of speech or an unconstitutional condition to impose greater liability (in the form of a negligence standard) as a penalty for speech that is unrelated to the liability imposed?

Would it be a less speech-restrictive alternative simply to ban private placements?

V. "Gun-jumping" in Connection with Public Offerings

Section 5(c) of the 1933 Act prohibits offers of securities (unless an exemption is available) prior to the filing of a registration statement. Section 5(b)(1) prohibits such offers after the filing of the registration statement, if the offers are in writing and are made by any document other than the SEC-filed prospectus.[8] The common term for the making of illegal offers is "gun-jumping."

The SEC broadly construes the term "offer." In effect, the SEC's view is that an offer includes any communication that conditions the market for a security. That is, of course, an intentionally broad and subjective test that effectively discourages communications that could arguably relate to a proposed securities offering.

The securities markets coped for many years with the SEC restrictions on communications in connection with public offerings. The arrival of the Internet has created additional pressures, however, given the SEC's conclusion that electronic communications should be classified as "writings" for gun-jumping purposes. Here are some of the resulting anomalies:

- A broker can telephone a customer and recom mend a new offering, but the broker cannot safely send the same message in the form of an e-mail or letter;
- electronic "roadshows" have to be structured as if they were closed-circuit TV programs; and
- issuers about to commence a public offering are forced to examine, and perhaps purge, their websites.

Why the SEC Adopted the Rule. Congress created the distinction between oral and written offers in 1933. It clearly intended to limit written offering material to the SEC-filed prospectus, but it did not attempt to regulate the means by which people communicate most often (*i.e.*, oral communication, whether in person or by telephone). The distinction is undoubtedly based on the premise that investors are more easily defrauded by written offering material than by oral communications.

The SEC lacked exemptive authority in this area until 1996. Instead of using its exemptive authority to relax the rules for informal written communication, however, it has consistently taken the position that electronic communications – the means by which many people now communicate most often – are "written" communications and therefore within the gun-jumping prohibitions.

Alternatives. The SEC has acknowledged that "[t]echnological innovations that permit instantaneous communications were a driving force" behind the securities markets of the 1990s, and it would undoubtedly take the same position insofar as the 21st century is concerned. Moreover, it admits that the traditional "facts and circumstances" test for construing whether a communication is an "offer" has been difficult to apply and has led to significant restrictions on communications. It has also confessed that its guidance has been "vague" and "general" and difficult to apply in practice.

In the "aircraft carrier" release of 1998, the SEC proposed to permit a broader range of oral and written communications, but, unfortunately, only on condition that they be incorporated into the registration statement filed with the SEC (and thus become subject to negligence-based liability under Section 11) or be publicly filed (thus increasing the odds of class action litigation under Section 12(a)(2)).

The staff has recently confirmed that it is again addressing these problems and that its proposals will likely include a requirement that written offering material not contained in the prospectus be publicly filed.

An ABA group is proposing a dramatic reduction of the prohibitions on non-prospectus written offering material, without a public-filing requirement. Persons who use such material would be required to maintain a record of such material, and they would have antifraud liability for such material to the persons who had received it from them.

Questions Presented. While an offer of securities is an example of commercial speech, are all communications related to an offer also commercial speech? Are all communications that "condition" the market commercial speech?

Who finally decides whether a communication is an "offer" for purposes of deciding which First Amendment standard to apply? Should there be any deference to the regulatory definition of an "offer" when considering which First Amendment standard to apply? Is the regulatory definition overbroad for First Amendment purposes? Is it too vague to provide the certainty necessary for restrictions on speech?

Is the discrimination between written and oral communications a valid time-place-manner restriction? Is it a content-based restriction? Are the distinctions between written and oral communications, and the treatment of web-based communication, reasonable distinctions even under more lenient First Amendment standards? Is there any evidence for the premise that investors are more easily defrauded by written communications? What standard of proof should be applied to SEC claims regarding such differential risk?

Would a requirement that "offers" be made public constitute compelled speech? Does the restriction on nonpublic communications threaten any First Amendment values? Is it a less restrictive alternative than requiring all "offers" be contained within a prospectus?

Would a record-keeping requirement coupled with liability for fraud be a still less restrictive alternative?

VI. Tender Offer Filing Requirements

What the Rule Does. After the commencement of a tender offer, Rule 14d-9 states that any person who is an employee or shareholder of the target company and who makes any "solicitation or recommendation" to the target company's shareholders must file with the SEC (with a copy to the bidder and to the target) a Tender Offer Solicitation/Recommendation Statement on Schedule 14D-9. (The rule has an exemption for attorneys, banks, brokers, fiduciaries, or investment advisers who are not participating in the tender offer in more than a ministerial capacity and who furnish information and/or advice regarding the tender offer to their customers or clients on an unsolicited basis or pursuant to a contract.)

The press recently reported on an employee of Willamette Industries Inc. who had set up a website (JustSayNoWey.com) for the purpose of opposing Weyerhaeuser's hostile tender offer for Willamette. [9] The SEC reportedly communicated with the Willamette employee to the effect that the employee could not continue to operate the website unless he prepared and filed a Schedule 14D-9, an endeavor that would reportedly have cost the employee as much as $50,000. The employee therefore shut down the website just three weeks after its launch.

Why the SEC Adopted the Rule. The SEC's tender offer rules are designed to ensure that shareholders confronted with a tender offer for their shares have adequate information on which to base an investment decision. This includes information about the offer and the person making the offer (the "bidder"), and it includes information about any recommendation by the management of the company for whose shares the offer is being made (the "subject company"). To prevent evasions, the rule also covers recommendations or solicitations by certain persons connected with the bidder or the subject company as well as by any person acting on behalf of the bidder or the subject company.

The SEC's concerns in this area are understandably increased by the availability of the Internet as a means for communicating recommendations or solicitations about tender offers on a mass, instantaneous, and anonymous basis.

Alternatives. The SEC's proxy solicitation rules were at one time so broad that "almost every expression of opinion concerning a publicly-traded corporation" could have been viewed as a regulated proxy solicitation. "Thus, newspaper op-ed articles, public speeches or television commentary on a specific company could all later be alleged to have been proxy solicitations in connection with the election of directors, as could private conversations among more than 10 shareholders."[10] In particular, institutional investors could not safely discuss among themselves their dissatisfaction with management of a portfolio company without risk that their communications could constitute a regulated proxy solicitation.

Addressing these rules, the SEC acknowledged in 1992 that:

> A regulatory scheme that inserted the Commission staff and corporate management into every exchange and conversation among shareholders, their advisors and other parties on matters subject to a vote certainly would raise serious questions under the free speech clause of the First Amendment, particularly where no proxy authority is being solicited by such persons. This is especially true where such intrusion is not necessary to achieve the goals of the federal securities laws.[11]

The SEC therefore adopted amendments to the proxy rules to create an exemption (Rule 14a-2(b)) for communications with shareholders where the person "soliciting" is not seeking proxy authority and does not have a special interest in the matter subject to a vote. Written soliciting activity in reliance on the exemption by persons with more than $5,000,000 in shareholdings was subject to a public notice requirement.[12] The SEC also amended the rules to permit a shareholder to publicly announce how it intended to vote, and to provide the reasons for that decision, without having to comply with the proxy rules.

The SEC does not appear to have considered similar relief under the tender offer rules.

Questions Presented. Are all solicitations or recommendations regarding a tender offer commercial speech? Does it matter who is doing the soliciting or recommending? If the speech is recommending *against* a commercial transaction, is it still commercial speech? If the recommendation or solicitation is based upon moral or political concerns rather than economic interests, does that alter the character of the speech or the level of scrutiny to be applied?

Does the exemption for private speech by attorneys, bankers, and other professionals constitute an improper discrimination against other parties such as employees? Does the extension of the filing requirements to non-controlling employees of a tendering or target company sweep too broadly and suppress more speech than is necessary for the alleged goals of the filing requirements?

Can the goal of assuring that shareholders have adequate information about a tender offer ever justify suppressing speech about that offer? Is the filing requirement (with its associated cost) an undue burden on speech? Is there any evidence that failures to file a solicitation or recommendation have defrauded or misled any shareholders? Is there any evidence that the filing requirement has mitigated any such harms? Does the filing requirement advance any government interest at all where the communication in question is otherwise public, such as in the case of a web site accessible to all?

Does the filing requirement eliminate the ability to engage in anonymous speech regarding a tender offer? Would the lack of anonymity deter certain speakers or lead to retaliation against such speakers? What impact would it have on dissident shareholders or employees who oppose management's favored position?

Is there any First Amendment distinction between communications regarding tender offers and communications regarding proxy solicitations? What are the justifications for the differences in the treatment of the two types of communications? Do the proxy solicitation rules themselves suppress more speech than allowed by the First Amendment? Does the reach of a communication affect the First Amendment analysis of restrictions on that communication? Does a more broadly disseminated communication deserve more or less First Amendment protection than a narrowly distributed communication?

VII. MSRB Rule G-37 ("Pay-to-Play" Regulation)

What the Rule Does. In response to pressure from the SEC, the Municipal Securities Rulemaking Board ("MSRB") in 1994 adopted its "pay-to-play" rules. Briefly, Rule G-37(b) prohibits any broker, dealer or municipal securities dealer who has contributed to "an official of [a municipal] issuer" from "engaging in municipal securities business with [that] issuer" for a period of two years after the contribution. There is an exception for contributions of up to $250 to any official for whom the donor is eligible to vote. Other provisions of the rule are designed to prevent evasions of the primary provisions of the rule.

The effect of the rule is therefore to prevent municipal securities professionals from making political contributions to particular candidates unless they (and their firms) are willing to be foreclosed from doing business with the candidate's jurisdiction for a period of two years. To preserve their ability to do business without interference from the rule, most securities firms with a municipal bond component have prohibited all relevant contributions by their covered employees. (The effort has not been without its failures. For example, a well-known firm was barred for two years from doing business in the State of Massachusetts because an employee made a contribution to the U.S. Senatorial campaign of the then-Governor of Massachusetts.)

Why the MSRB Adopted the Rule. The SEC has said that Rule G-37 serves two important purposes. The first is that it protects investors in municipal bonds from fraud. The second is that it protects underwriters of municipal bonds from unfair and corrupt market practices.

An appellate court has expressed skepticism about whether the rule really protects investors, but it found to be "self-evident" the SEC's justification based on fair competition.[13]

Alternatives. The SEC rejected disclosure and recordkeeping requirements as an alternative to the two-year prohibition in Rule G-37. An appellate court found that disclosure and recordkeeping might serve the SEC's first stated purpose of the rule, *i.e.*, protecting investors, but as noted above the court was not persuaded that this was in any event an important purpose of the rule. On the other hand, it found that disclosure and recordkeeping would not be "even almost equally effective" as the two-year prohibition in achieving the SEC's purpose of protecting the integrity of the market.

Questions Presented. Is a restriction on political speech and contributions an unconstitutional condition on the ability to deal in municipal bonds? Is the proper standard of review for industry-specific restrictions on campaign contributions strict scrutiny or something else?

What is the harm addressed by Rule G-37? Is it harm to investors, harm to the municipality, or harm to the dealers themselves? Is there any evidence at all that political contributions have resulted in deficient bond services? Is there any evidence that investors have been defrauded as a result of political contributions by bond dealers? Is there any evidence that municipal officials use their authority to award bond contracts in exchange for political contributions? Are existing public corruption laws sufficient to punish and deter such blackmail?

Regarding risk to investors, would a disclosure requirement be sufficient to alert them to any perceived risk created by political contributions and thus let the market account for such risk? Would it be sufficient to let the voting public police any abuse of office by municipal officials?

Is the concern for "fairness" as between competing municipal bond dealers a sufficient justification for a broad restriction on the speech of those dealers?

Is there any suggestion that municipal bond contributions pose a risk of political corruption that is different from contributions by others that do business with government entities? Is there any justification for treating bond dealers differently than others? Are existing state and federal limitations on campaign contributions sufficient to mitigate or eliminate any feared corruption? Is there a compelling government interest in the marginal reduction in the contribution cap between Rule G-37 and existing laws?

What is the justification for the prohibition against contributions to candidates for whom the dealer cannot vote? Does the inability to vote for a candidate lessen or increase a person's First Amendment interest in supporting that candidate? Does it matter whether that candidate would have an impact on your private or business life if elected? Is there any greater risk of corruption merely because a dealer is unable to vote for a candidate?

Is the potential coercion of contributions from bond dealers a compelling interest for First Amendment purposes? Would it be a less restrictive alternative to disqualify the government official receiving the contribution rather than the dealer making the contribution? Would it be a less restrictive alternative simply to require competitive bidding for dealers of any municipal bonds that will be sold in interstate commerce?

Footnotes

[1] As proposed, the rule would have triggered a public disclosure requirement if the company disclosed material nonpublic information to the financial press. Certain news organizations objected to this part of the rule, and the final rule permits disclosures to the financial press without triggering a public disclosure obligation.

[2] An eligible shareholder is one who has continuously held shares worth at least $2,000 (or at least 1% of the company's shares eligible to vote) for at least one year.

[3] SEC No-action Letter, *Cracker Barrel Old Country Store, Inc.* (available October 13, 1992).

[4] SEC Release No. 34-40018 (May 21, 1998).

[5] *SEC v. Transamerica Corp.*, 163 F.2d 511, 518 (3d Cir. 1947).

[6] SEC Release No. 34-39093 (September 18, 1997).

[7] 4 Loss & Seligman, *Securities Regulation* 2051-52 (3d ed. 1990).

[8] Certain communications such as research reports are exempted by rule.

[9] *The Wall Street Journal*, May 7, 2001.

[10] SEC Release No. 34-31326 (October 16, 1992).

[11] *Id.*

[12] *Id.* Corporate commenters on the proposal criticized the absence of a public notice requirement for shareholders' oral conversation. The SEC justified the distinction on the basis that it had determined that "the burdens of requiring a notice to the federal government of oral communications . . . [except in the case of the "special interest" exceptions built into the rule] are not justified by any benefit to be derived therefrom . . . ." The SEC also took issue with commenters' arguments against the distinction:

> The Commission disagrees with some commenters who argue that oral and written communications are largely indistinguishable in terms of the purposes of the proxy rules. Written analyses can be far longer and more complex than most oral conversations. They can include extensive quantities of data – often displayed using charts and graphs. Written documents can be circulated by the recipient to any number of persons in the same organization or outside, while an oral conversation cannot generally be "republished" to persons other than the original participants. Written documents can be saved and referred to over and over again. Oral conversations, by contrast, are more ephemeral. Moreover, the burden of mailing one extra copy of something already sent to more than 10 other shareholders is minimal compared with a requirement that oral conversations must be memorialized and reported to the government.

At the same time, the SEC conceded that "[t]he First Amendment applies equally to written and oral communications." On the other hand, it continued, "regulatory requirements can impose different degrees of burden on different types of speech."

[13] *Blount v. SEC*, 61 F.3d 938 (D.C. Cir. 1995).