Disclosure is Speech: Imposing Meaningful First Amendment Constraints on SEC Regulatory Authority

Lloyd L. Drury III
Loyola University New Orleans College of Law

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DISCLOSURE IS SPEECH: IMPOSING MEANINGFUL FIRST AMENDMENT CONSTRAINTS ON SEC REGULATORY AUTHORITY

LLOYD L. DRURY, III

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*Visiting Professor, Loyola University New Orleans College of Law.
I. INTRODUCTION

In the summer of 2004, the stock market was abuzz over the upcoming Google, Inc. initial public offering of its common stock. The secretive company from Silicon Valley built an impressive and popular search engine and recruited some of the area’s top talent to its campus in Mountain View, California. It further drove investor interest by its unorthodox approach to corporate communication and by shunning the established investment banks to conduct an innovative Dutch auction style of offering. However, just days before the offering was to commence, the financial press announced that it would likely need to be delayed. Did the company announce poor financial results? Embroil itself in an accounting scandal? No, Larry Page and Sergey Brin, Google’s young founders, gave an interview to Playboy magazine. The concern was that the interview violated a Securities and Exchange Commission-imposed (SEC) quiet period between the time that the company filed its offering documents and the time when the offering was to commence. Google later amended its SEC filings to specifically address the Playboy interview, and the offering was allowed to proceed. This Article addresses the following questions:


6. Id. For an extended discussion of these provisions, see infra notes 184–86 and accompanying text.

7. In order to proceed with the offering, Google included additional disclosures in its prospectus, including the following:

   Information about Google has been published in an article appearing in the September 2004 issue of Playboy Magazine and entitled “Playboy Interview: Google Guys.” The text of the article, which is included in this prospectus as Appendix B, contains information derived from an interview of Larry and Sergey conducted in April 2004, prior to the filing of our registration statement of which this prospectus is a part. The article presented certain statements about our company in isolation and did not disclose many of the related risks and uncertainties described in this prospectus. As a result, the article should not be considered in isolation and you should make your investment decision only after reading this entire prospectus carefully.

   You should carefully evaluate all the information in this prospectus, including the risks described in this section and throughout the prospectus. We have in the past received, and may continue to receive, a high degree of media coverage, including coverage that is not directly attributable to statements made
How did the SEC get the power to decide if people can give magazine interviews, and is that a power that the SEC should have?

The idea that investors should be allowed to make their own decisions regarding the purchase and sale of securities is at the core of the federal system of securities regulation. This freedom depends on issuers of securities informing prospective investors of all material information about both the securities and the company issuing them. In other words, disclosure eliminates the need for substantive regulation. Corporate disclosure is no more than what nonlawyers call speech, and the protection of speech is at the heart of the First Amendment to the United States Constitution. However, no less of an authority than the United States Supreme Court has declared that the regulation of securities does not fall within the protection of the First Amendment. This lack of recognition comes from the traditional principle that commercial speech is less worthy of protection than other forms of expression, and that the regulation of the purchase and sale of securities is a commercial activity that does not even deserve the limited protection afforded to commercial speech.

Two patterns have emerged over the last thirty years that warrant a reconsideration of this approach. First, the Supreme Court has significantly broadened the protections afforded to commercial speech. This increased protection reflects a concern for the dissemination of truthful information and a willingness to protect First Amendment values, even when another regulatory regime is present. Second, economic research and related legal scholarship suggest that there is less need for the SEC to protect investors than exists in the case of normal consumer protection, where advertising enjoys full status as commercial

by our officers and employees. You should rely only on the information contained in this prospectus in making your investment decision.

We do not believe that our involvement in the Playboy Magazine article constitutes a violation of Section 5 of the Securities Act of 1933. However, if our involvement were held by a court to be in violation of the Securities Act of 1933, we could be required to repurchase the shares sold to purchasers in this offering at the original purchase price for a period of one year following the date of the violation.

Google, Inc. Prospectus, supra note 2, at 21–22. The Playboy Magazine interview is reprinted in Appendix B to the prospectus. Id. app. B.


9. For a description of the federal securities laws, see infra Part II.A.


11. U.S. Const., amend. I.

12. See, e.g., Paris Adult Theatre 1 v. Slaton, 413 U.S. 49, 61 (1973). For a more detailed discussion, see infra Part II.A.


15. See infra Part II.B.
speech. This Article argues that, upon the convergence of these two trends, the Court should apply its newly-robust commercial speech protection to regulations issued by the SEC. If given such protection, certain parts of these regulations would be struck down as unconstitutional infringements on the First Amendment rights of corporations, and newly proposed regulations would be more carefully analyzed for their impact on corporate speech rights.

The Supreme Court has alternately defined commercial speech as “expression related solely to the economic interests of the speaker and its audience,” or as speech that proposes a commercial transaction. The Court has singled out this form of expression and afforded it a lower level of protection under the First Amendment. The degree of protection, however, has grown over time. For many years, the Court refused to protect commercial speech at all, if ever so slightly. In 1976, the Court finally acknowledged that commercial speech fell under the First Amendment. In the 1980 case Central Hudson Gas & Electric Corp. v. Public Service Commission, the Court set out a four-part test for commercial speech that determines whether government should be allowed to regulate this speech, even if it is protected in some manner. For more than twenty-five years, the Court has been exploring the limits of this protection as defined by the four-part test.

There is a broad range of communications that corporations and other participants in the capital markets make at the behest of the SEC. For example, corporations periodically report on their financial condition and the results of operations, submit proxy solicitations, report unusual events, discuss the professional history and ownership interests of management and board members, and describe prospective offerings of securities. Each of these communications is made with the purpose of informing the potential investment decisions of members of the public.

16. See infra Part III.
17. See infra Part IV.
22. 447 U.S. at 566.
23. See infra Part II.B.
28. 15 U.S.C. § 77e (2000); see also 17 C.F.R. § 230.135 (2006) (explaining the conditions a notice of a proposed offering must meet so that it will not, itself, be considered an offer).
These communications are mandated by the SEC, but no court has indicated that they should be considered commercial speech. The case law relating to commercial speech is confined to product or service advertising, but the Supreme Court has recently expressed an interest in considering the expansion of the doctrine beyond pure product advertising. Securities regulation is a natural candidate for the extension of the commercial speech doctrine. The SEC’s mandatory disclosures made by issuers relate directly to the purchase and sale of securities. The SEC actively seeks both to require and prohibit certain types of speech, and the legal and finance literature support the contention that market participants will continue to seek out this type of information. Furthermore, the Court has not shown reluctance in involving itself in speech regulations that are the product of an otherwise comprehensive regulatory structure.

If this speech is commercial speech, the regulations calling for corporations to speak in this manner must meet the requirements of the Central Hudson test, as it has been interpreted for more than twenty-five years, in order for them to be constitutional. The four parts of the test are as follows: the communication must not be false or misleading, the regulation must relate to a substantial government interest, the regulation must directly advance the state interest involved, and the government interest must not be able to be served as well by a more limited restriction.

Examination of specific SEC regulations calls into question the ability of some regulations to pass the Central Hudson test, particularly the final two elements. Most in danger of invalidation are those regulations that prohibit truthful speech. The SEC has broadly interpreted its mandate to ensure market integrity, particularly in the area of preventing the distribution of false or misleading information. It has issued regulations that contain prophylactic prohibitions on certain types of speech based on the fear that the increased mix of data will mislead investors. It is just this type of paternalism that recent commercial speech cases reject.

Also, in the last few years, the SEC has put forth a staggering number of new regulations. Each proposed regulation goes through an elaborate process of

29. Actually, a corporation is only subject to periodic reporting requirements if it meets certain threshold levels of asset value and number of shareholders. See 15 U.S.C. §§ 78f(a), (g) (2000 & Supp. IV 2004).

30. See Kasky v. Nike, Inc., 45 P.3d 243 (2002), cert. granted, 537 U.S. 1098, 1099–110 (2003), cert. denied, 539 U.S. 654, 657 (2003) (per curiam) (holding that Nike’s public statements defending labor practices were commercial speech that would be regulated to prevent consumer protection). The fact that the Supreme Court initially granted certiorari shows it has some interest in the area.

31. See, e.g., Burt Neuborne, The First Amendment and Government Regulation of Capital Markets, 55 BROOK L. REV. 5, 28–30 (1989) (arguing that “hearers” have a strong interest in receiving information that improves their ability to make informed choices).

32. See infra Part IV.

33. See infra Part IV.

34. Most of these regulations have been in connection with the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (Supp. 2004)). This Act and the related SEC rules have introduced many new and often burdensome regulations to issuers. For a recent analysis questioning the value of this law, see Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 YALE L.J. 1521 (2005).
proposal, comment, and modification, adoption or rejection.\textsuperscript{35} However, nowhere in this process is the constitutionally protected right to speech considered, much less protected. By bringing First Amendment considerations into focus, it is likely that the SEC will be able to take these concerns into account before forcing significant compliance costs on issuers.

The idea that corporate speech should be protected under the First Amendment is not new. Others have commented on this matter before, and with great insight and passion.\textsuperscript{36} However, circumstances were not right at that point in time to impose meaningful change. The commercial speech doctrine remained limited by a now-abandoned precedent that significantly reduced the doctrine’s practical application.\textsuperscript{37} Some commentators were not interested in applying current law but rather were arguing for full or higher protection of speech, placing commercial speech on the same plane as political or religious expression.\textsuperscript{38} The aim of this Article is narrower and more attainable. It argues that, with the maturation of the commercial speech doctrine, a logical extension of current precedent should allow for scrutiny of securities regulation on the same terms as other commercial speech.

Specifically, this Article contends that doctrinal developments in First Amendment law, when combined with insights provided by modern finance theory


\textsuperscript{36} See, e.g., Henry N. Butler & Larry E. Ribstein, Corporate Governance Speech and the First Amendment, 43 U. KAN. L. REV. 163, 163 (1994) (discussing the appropriate levels of First Amendment protection for corporate governance speech and suggesting that at least one category of corporate communication—proxy solicitation—should be treated as political speech); Aleta G. Estreicher, Securities Regulation and the First Amendment, 24 GA. L. REV. 223, 225 (1990) (characterizing commercial speech as contributing to the social commitment to decisionmaking and arguing for protection of some securities-related expression); Neuborne, supra note 31, at 62 (concluding that SEC regulations are vulnerable to First Amendment attack, but that a substantial increase in court challenges is unlikely); Nicholas Wolfson, The First Amendment and the SEC, 20 CONN. L. REV. 265, 265–66 (1988) (examining the impact of the First Amendment on the principal areas of SEC regulation).

\textsuperscript{37} See Posadas de P.R. Assocs. v. Tourism Co. of P.R., 478 U.S. 328, 344 (1986). For a full discussion of Posadas, see infra Part II.B.

\textsuperscript{38} See, e.g., Estreicher, supra note 36, at 225 (“To view commercial speech as some second-class species of expression is to ignore the contribution such speech makes to the societal commitment to decentralized decisionmaking.”); Alan Howard, The Constitutionality of Deceptive Speech Regulations: Replacing the Commercial Speech Doctrine with a Tort-Based Relational Framework, 41 CASE W. RES. L. REV. 1093, 1095 (1991) (contending that “many more deceptive speech regulations should and will be subjected to First Amendment challenge and review”); Larry E. Ribstein, The Constitutional Conception of the Corporation, 4 SUPREME CT. ECON. REV. 95, 96 (1995) (explaining that under the “corporate person” theory, corporate speech is produced by artificial legal entities, and therefore should not be accorded the same First Amendment protection as speech by individuals, but that under the “contract” theory, the corporate façade disappears and the rights should be accorded to the individual speakers); Wolfson, supra note 36, at 266–77 (arguing that the underlying reasons for protecting political speech also exist with respect to commercial speech). But see Michael P. Dooley, The First Amendment and the SEC: A Comment, 20 CONN. L. REV. 335, 337 (1988) (“[T]he task that Wolfson has undertaken is to convince us that traditional corporate disclosure is either speech necessary to the process of representative self-government, or, somewhat more controversially, speech necessary to individual self-fulfillment”).
and historical SEC practice, argue in favor of extending First Amendment protection to corporate speech made in the form of SEC disclosures. Part II of the Article describes the structure of the SEC’s mandatory disclosure system, the current state of the case law removing it from scrutiny under the First Amendment, and the development of the commercial speech doctrine. Next, Part III pursues the idea of protecting SEC disclosures as commercial speech, based on its similarity to those forms of speech currently covered by the doctrine. Finally, Part IV analyzes SEC regulations under commercial speech principles and concludes that those prohibiting the dissemination of truthful information would be struck down. However, the Article finds the vast majority of federal securities regulations—rules that either require disclosure or place conditions on the manner of disclosure—consistent with the First Amendment.

II. AN OVERVIEW OF THE MANDATORY DISCLOSURE REGIME AND THE COMMERCIAL SPEECH DOCTRINE

This part introduces the primary statutes and rules setting up the mandatory disclosure system, discusses the goals of the legislation, and assesses the Supreme Court’s holdings on the constitutional status of the statutes and rules. Then, it describes the evolution of the commercial speech doctrine, from the refusal to consider commercial speech as protected under the First Amendment, to the announcement of the doctrine and its test, to the progression of the jurisprudence since the basic test was announced in Central Hudson.

A. The Mandatory Disclosure System

Congress enacted the two principal federal securities laws, in 1933 and 1934, during the Great Depression. Enactment of these laws were reactions to the speculation in capital markets prior to the market crash in 1929. The regulatory mechanism that Congress chose was to require companies wishing to issue securities to the public to make known certain facts about the issuer and the offering before offers or sales could be made. This approach contrasted with the substantive regulation of offerings, where the government could prohibit offerings that were too risky, or prohibit purchasers from participating in offerings that were unsuitable. Congress created the SEC to oversee and regulate the capital markets and the securities industry.

40. See id. §§ 78a–78mm.
The second of the two major securities laws chronologically, the Securities Exchange Act of 1934 ("34 Act), 44 serves as the primary foundation of today’s disclosure regime. It requires a company that is registered on a national securities exchange or that attains a certain threshold of total shareholders and assets to periodically report certain information about itself. 45 Every year, a reporting company must provide a comprehensive report on its operations. 46 This disclosure must be updated each quarter. 47 In the interim, the occurrence of important, specified events requires an additional notice to the SEC. 48 The ’34 Act also requires other extensive disclosures, including those relating to proxy communications, 49 beneficial ownership reporting, 50 and tender offer filings. 51 Finally, the ’34 Act provides for liability, most notably in Section 10b 52 and via Rule 10b-5. 53

The previous year, Congress passed the Securities Act of 1933 ("33 Act). 54 One of the primary functions of the ’33 Act is to dictate how issuers get themselves into the ’34 Act disclosure regime. 55 Its primary requirement in this regard is to mandate registration of all offerings and sales of securities unless the Act contains a particular exemption from the registration requirement. 56 The ’33 Act provides exemptions for both transactions 57 and securities. 58 Also, the ’33 Act provides for civil 59 and criminal liability, 60 particularly for misstatements in a prospectus.

There are other, less well known acts that are part of the federal securities laws. The Trust Indenture Act of 1939 61 regulates debt securities, and the Investment Company Act of 1940 62 and Investment Advisors Act of 1940 63 regulate aspects of the securities industry. Congress recently repealed the Public Utility Holding

45. 15 U.S.C. §§ 78l(a), (g).
50. Id. § 78p.
55. Of course, the ’34 Act contains provisions that require some companies to make disclosures even though they haven’t completed a public offering under the ’33 Act. See 15 U.S.C. § 78l(g) (2000 & Supp. IV 2004).
57. Id. § 77d.
60. Id. § 77l(a)(2).
Company Act of 1935, but for seventy years it regulated the internal affairs of public utilities throughout the United States.64 This Article focuses on the core provisions of the '33 and '34 Acts, but principles relating to these Acts should apply to the other securities laws as well.

The intent of these laws is to promote efficiency, fairness, and the integrity of capital markets.65 These goals have been reiterated over the years and remain a central focus of the SEC today.66 In interpreting these laws, the Court has never squarely addressed the question of an issuer’s First Amendment rights relating to SEC disclosure requirements.67 Nevertheless, there has been a strong presumption in other First Amendment cases that securities regulation was not subject to constitutional protections available for free speech. Before the adoption of the commercial speech doctrine, the Court noted approvingly in Paris Adult Theatre I v. Slaton68 that “both Congress and state legislatures have . . . strictly regulated public expression by issuers of and dealers in securities . . . commanding what they must and must not publish and announce.”69 In Ohralik v. Ohio State Bar Ass’n,70 the Court more clearly expressed the presumption that SEC disclosures were beyond the scope of First Amendment protection: “Numerous examples could be cited of communications that are regulated without offending the First Amendment, such as the exchange of information about securities.”71

B. The Commercial Speech Doctrine

1. Initial Recognition of Commercial Speech Protection

Until 1976, no form of commercial speech received any sort of First Amendment protection. The Court provided justification for this dismissive treatment in Valentine v. Christensen.72 In Valentine, a New York businessman

65. Although, some scholars have quibbled with the exact characterization. See, e.g., Edmund W. Kitch, The Theory and Practice of Securities Disclosure, 61 BROOK. L. REV. 763, 764 (1995) (claiming accuracy, rather than efficiency, as a primary goal of securities regulations).
66. After the failure of disclosure to alert markets to the fraud at Enron, some commentators began to question the ability of disclosure rules to reach these goals. See Steven L. Schwarz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. ILL. L. REV. 1, 6–7 (2004) (arguing for supplemental protections to the disclosure mandates).
68. 413 U.S. 49 (1973).
69. Id. at 61–62.
71. Id. at 456 (citing SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 847–48 (2d Cir. 1968)). For an extended discussion of areas that are outside of the scope of First Amendment protection, see Frederick Schauer, The Boundaries of the First Amendment: A Preliminary Exploration of Constitutional Salience, 117 HARV. L. REV. 1765 (2004).
wanted to distribute a leaflet advertising an exhibition of a former navy submarine
that he owned but was enjoined by the New York police for violating the city
ordinance relating to the distribution of handbills.\textsuperscript{73} He appealed the injunction on
First Amendment grounds.\textsuperscript{74} The Court held that, although a municipality “may not
unduly burden or proscribe” the “exercise of the freedom of communicating
information and disseminating opinion,” the “Constitution imposes no such
restraint on government as respects purely commercial advertising.”\textsuperscript{75} For several
decades, the Court read this decision to exclude commercial speech from the
protection of the First Amendment.

The Supreme Court reversed its stance in \textit{Virginia State Board of Pharmacy v.
Virginia Citizens Consumer Council, Inc.}\textsuperscript{76} In this case, a group of citizens sued to
challenge a state statute that forbade pharmacists from advertising the prices of
prescription drugs.\textsuperscript{77} The Court held that the statute was an unconstitutional
restriction on protected speech.\textsuperscript{78} The Court noted that First Amendment protection
is granted not just to the speaker, but to the communication itself, thus protecting
both speaker and listener.\textsuperscript{79} It then outlined why commercial speech fell within the
First Amendment. First, purely economic motives do not disqualify speech.\textsuperscript{80} Next,
consumers have a strong “interest in the free flow of commercial information.”\textsuperscript{81}
Finally, the public interest is served by the efficient allocation of resources,
accomplished through the free flow of commercial information.\textsuperscript{82} While
recognizing that it is permissible to regulate commercial speech, the Court
concluded that the state could not “completely suppress the dissemination of
concededly truthful information about entirely lawful activity, fearful of that
information’s effect upon its disseminators and its recipients.”\textsuperscript{83} Over the last thirty
years, the Court has tried to determine exactly what types of suppression do fit
under the First Amendment.

2. Developing a Test for Permissible Regulations

The Court first set forth its test for determining whether government regulation
of commercial speech is permissible in \textit{Central Hudson Gas & Electric Corp. v.
Public Service Commission}.\textsuperscript{84} In \textit{Central Hudson}, the Public Service Commission

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{73}] \textit{Id.} at 53.
\item[\textsuperscript{74}] \textit{See id.} at 54.
\item[\textsuperscript{75}] \textit{Id.} at 54.
\item[\textsuperscript{76}] 425 U.S. 748, 770 (1976).
\item[\textsuperscript{77}] \textit{Id.} at 749–50 (citation omitted).
\item[\textsuperscript{78}] \textit{Id.} at 770.
\item[\textsuperscript{79}] \textit{Id.} at 756. For an argument that the First Amendment analysis should broadly consider other
parties’ interests, see Neuborne, \textit{supra} note 31, at 28–30 (describing a “hearer centered” conception of
free speech protection, in contrast to the speaker centered analysis that dominates today).
\item[\textsuperscript{80}] \textit{Va. State Bd. of Pharmacy}, 425 U.S. at 762.
\item[\textsuperscript{81}] \textit{Id.} at 763.
\item[\textsuperscript{82}] \textit{Id.} at 765.
\item[\textsuperscript{83}] \textit{Id.} at 773.
\item[\textsuperscript{84}] 447 U.S. 557 (1980).
\end{enumerate}
\end{footnotesize}
of the state of New York banned all promotional advertising by electric utilities. Central Hudson challenged this restriction, citing the right to free speech recognized in Virginia State Board of Pharmacy. The Court determined that the state’s ban was broader than what measures could be permitted consistent with the protections of the First Amendment.

The Court applied a four-part test in reaching its conclusion. First, the communication must not be false or misleading. Next, the regulation must relate to a substantial government interest. Third, the regulation must directly advance the state interest involved. Lastly, the government interest must not be able to be served as well by a more limited restriction. Since the creation of this test, subsequent cases have dealt mostly with interpretation of the third and fourth prongs—what it means to directly advance the governmental interest and how to determine the adequacy of a more limited restriction. In fact, Central Hudson itself turned on the Court’s determination that the ban on advertising was broader than necessary to accomplish its objectives. This finding set the tone that a certain degree of scrutiny would be applied to the determination of means and ends.

3. Willingness to Address Regulated Fields

One objection commentators raise to the Court’s imposition of First Amendment principles to commercial speech generally, and to securities regulation particularly, is that other regulatory structures are already in place. Three cases decided around the time of Central Hudson confirmed the Court’s willingness to review speech restrictions, even in heavily regulated areas. Ohralik v Ohio State Bar Ass’n and In re R.M.J. both dealt with speech restrictions on attorney advertising under state bar rules. Comprehensive regulation of attorneys has long

85. Id. at 558–59.
86. See id. at 560.
87. Id. at 570.
88. Id. at 566.
89. Id.
90. Id.
91. Id.
92. Id.
93. Id. at 570.
94. Later Supreme Court decisions elaborated on exactly what level of scrutiny ought to be applied to each prong of the test. The idea that the regulation at issue must directly advance the state interest was visited in a number of cases. For example, in Rubin v. Coors Brewing Co., 514 U.S. 476, 478 (1995), the Court examined a federal law prohibiting beer labels from displaying alcohol content. It held that this law did not directly further the interest in protecting public health by minimizing competition based on alcohol content. Id. at 488. The Court pointed to other provisions in the act that might allow advertising based on strength—provisions that allow high content beer to call itself “malt liquor,” and that require wine and spirits to include on its labels the exact information that it forbids beer from including. Id. at 488–89. For a general discussion of this matter, see Butler & Ribstein, supra note 36, at 169.
been considered a matter of state concern. In R.M.J., the Court addressed an objection to the regulation of attorney advertising that was only potentially misleading and upheld the regulation. In Ohralik, the Court allowed Ohio to regulate face-to-face solicitations of potential clients, even though the solicitation was speech, because the speech was intended to further a business transaction over which the state had regulatory authority. Even though the Court upheld these regulations, it signaled an early interest in review of speech, even if that speech is otherwise subject to regulatory scrutiny.

This interest in regulated areas continued in Zauderer v. Office of Disciplinary Counsel, which involved an Ohio rule that required attorneys to make certain disclosures in advertisements about contingency fee rates. The Court upheld the requirement but distinguished this mandatory disclosure requirement from a regulation that restricts the flow of information. Because it distinguished between prohibitions on speech and additional disclosure requirements, Zauderer was an important step in the Court’s annunciation of a robust commercial speech doctrine including, maybe especially, areas that are of regulatory interest to other arms of government.

A recent case illustrates that the Court still embraces serious scrutiny of heavily regulated fields. In Thompson v. Western States Medical Center, the Court upheld a challenge to the Food and Drug Administration Modernization Act. Specifically, it found that the proposed ban on advertising and promoting compound drugs was broader than necessary under the fourth prong of the Central Hudson test. The Court made this ruling in light of the broad authority of the Food and Drug Administration over the process of developing, producing, and disseminating drugs.

4. Narrow Focus—The Vice Exception

After announcing the commercial speech doctrine in Virginia State Board of Pharmacy and setting out the test in Central Hudson, the Court significantly limited the doctrine for the first time in Posadas de Puerto Rico Associates v. Tourism Co. of Puerto Rico. Posadas dealt with a proposed ban on advertising for casino gambling in Puerto Rico. The Court upheld this prohibition on the theory that the state’s power to entirely prohibit gambling implied the lesser power to restrict

98. R.M.J., 455 U.S. at 203, 207.
101. Id. at 633.
102. Id. at 650–51.
104. Id. at 360.
105. Id. at 373.
106. See id. at 361 (quoting 21 U.S.C. § 355(a) (2000)).
108. Id. at 330.
speech advertising the activity. Commentators believed that the case signaled a “vice” exception to the protections on commercial speech, so that if a legislature could prohibit or otherwise limit an activity, it could also take the lesser step of prohibiting advertising about it.

This vice exception had the potential to swallow the newly-created commercial speech doctrine. If Congress or a state or local government can prohibit speech as part of an attempt to eliminate or curtail certain types of behavior, then it has liberty to stop or hinder many types of expression. Many forms of commercial expression, from advertising of alcohol and cigarettes, to unhealthy fast food, to firearms, could be limited or prohibited if speech were allowed to be regulated as part of a larger regulatory scheme to impact behavior.

The Court seemed to extend this type of analysis in United States v. Edge Broadcasting Co. In Edge Broadcasting Co., the Court upheld a ban on lottery ads in nonlottery states, finding that the ban directly advanced the policies of both lottery and nonlottery states. This holding can only be justified under the Posadas reasoning; the ability to ban a lottery in one jurisdiction should include the lesser power to ban advertising relating to a lottery conducted elsewhere.

5. Renewed Vigor—44 Liquormart to Lorillard

The idea of a vice exception ended in 44 Liquormart, Inc. v. Rhode Island. In this case, the challenge was to laws prohibiting the advertisement of alcohol pricing. The Court not only struck down the restrictions as inconsistent with the First Amendment, but it went far beyond that. First, Justice Stevens explicitly rejected the vice exception that was recognized in Posadas. The Court then expressed its reluctance to condone government suppression of truthful speech, stating that it should be “especially skeptical of regulations that seek to keep people in the dark for what the government perceives to be their own good.”

109. Id. at 345–46.
112. Id. at 430–31.
113. See Posadas, 478 U.S. at 345–55.
114. 517 U.S. 484, 510 (Stevens, J., plurality) (1996); see also Developments in the Law—Corporations and Society, supra note 110, at 2281 (stating that the “‘vice principle’ remained an important holdout in the Court’s broadening protections for commercial speech. But the principle gave way in 44 Liquormart, when the Court overturned a statute forbidding the publication of liquor prices, rejecting earlier precedent and refusing to grant the ‘broad discretion to suppress truthful, nonmisleading information for paternalistic purposes’” (quoting 44 Liquormart, Inc., 517 U.S. at 510)).
115. 44 Liquormart, Inc., 517 U.S. at 489.
116. See id. at 486–87; see also Kathleen M. Sullivan, Cheap Spirits, Cigarettes, and Free Speech: The Implications of 44 Liquormart, 1996 Sup. Ct. Rev. 123, 126–27 (claiming that the decision called into question the reasons for treating commercial speech as a less protected category, distinct from fully protected speech).
117. Id. at 513–14 (Stevens, J., plurality).
118. Id. at 502–04 (Stevens, J., plurality).
The reasoning of *Liquormart* is important because it recognized the significance of truthful speech in First Amendment doctrine and the limited times when it is appropriate for the government to restrict the flow of truthful information for paternalistic reasons. Justice O’Connor also proposed narrow criteria indicating when the Court would consider these types of restrictions reasonable: the regulator has conducted a “careful calculation of the costs and benefits associated with the burden on speech,” there are no “less burdensome alternatives” available, and alternative methods of communicating the same material exist.

The Court extended and solidified this emphasis in *Lorillard Tobacco Co. v. Reilly*. *Lorillard* involved the validity of restrictions on tobacco advertising in Massachusetts. Concerns relating to tobacco usage are a particular and well-documented matter of interest to the government, both in healthcare spending and the protection of minors. However, the Court struck down point of sale tobacco advertising restrictions as contrary to the First Amendment. One lesson from the Court’s holding is that the Court is willing to protect speech rights no matter the strength of the regulatory objectives otherwise involved.

6. Ready to Step Beyond Product Advertising?

In its October 2003 term, the Court seemed to be willing to address how and to what extent the commercial speech doctrine applied to corporate speech beyond the simple product advertisement. Nike, Inc. conducted a public relations campaign in response to accusations that its labor practices in certain Asian countries were unfair. In *Kasky v. Nike*, a California citizen sued Nike under the state’s Unfair Competition Law and False Advertising Law. Nike responded to the suit, claiming protections under the First Amendment; however, the California Supreme Court rejected the claim. The U.S. Supreme Court originally agreed to hear this case to determine if these advertisements should be treated as commercial speech, even though they did not directly propose transactions, or given heightened scrutiny, as Nike hoped, because it considered the advertisements to address matters of public concern, or given lower scrutiny, as Kasky hoped, because the speech was allegedly false and misleading. Unfortunately for Nike and the development of

119. *Id.* at 529 (O’Connor, J., concurring) (quoting Cincinnati v. Discovery Network, Inc., 507 U.S. 410, 417 (1993)).
120. *Id.*
121. *Id.* at 529-30.
123. *Id.* at 532 (citation omitted).
124. See *id.* at 564-65.
125. *Id.* at 566-67.
127. *Id.* at 248-50.
128. *Id.* at 262.
130. See *Kasky*, 45 P.3d at 248.
the commercial speech doctrine, the Court dismissed the case on the grounds that
the writ of certiorari was improvidently granted; the Court allowed the California
Supreme Court decision to stand.\textsuperscript{131} Even though the Court did not use \textit{Kasky} to extend or clarify the reach of the commercial speech doctrine, the matter is
apparently on the Justices’ minds.

III. \textbf{SEC Disclosure Is Commercial Speech}

If the Court is looking for an area in which to apply the commercial speech
document beyond mere product advertising, the mandatory securities disclosure by
issuers under the ’33 and ’34 Acts would be an ideal candidate. This part argues
that SEC disclosures made by issuers should be considered commercial speech, and
these rules and regulations should be scrutinized under the prevailing commercial
speech standards. This treatment is appropriate for SEC disclosures because they
relate to proposing or effecting a transaction, hearers of this speech are less in need
of protection than consumers of ordinary products, and the disclosures do not meet
criteria for heightened First Amendment protection.

\textit{A. SEC Disclosures Propose a Transaction}

Although the Court has not presented a clear definition of commercial speech,
it has referred to commercial speech as speech proposing a commercial
transaction\textsuperscript{132} or speech relating to the economic interests of the participants.\textsuperscript{133}
These descriptions fit neatly with the core purpose of the capital markets.

When stripped to its essence, all securities disclosure required of issuers
involves something very similar to a tightly regulated advertisement for that
issuer’s securities. The ’33 Act regulates these advertising materials most
directly.\textsuperscript{134} If a company wants to issue securities, it must prepare the appropriate
disclosure documents, file them with the SEC, and use those documents, and only
the information contained in those documents, to offer the securities for sale.\textsuperscript{135} Just
as in normal product advertising, the seller (the issuing corporation) informs
the public about its product (securities) in the hopes that members of the public will
decide to make a purchase. The SEC participates in this process by ensuring that
the information given to potential investors is complete and accurate.\textsuperscript{136}

\textsuperscript{135} See 15 U.S.C. §§ 77f–77h (2000 & Supp. IV 2004); \textit{see also THOMAS LEE HAZEN}, The Law
of Securities Regulation, § 2.2 (rev. 5th ed. 2006) (providing an overview of section 2.2 of the ’33 Act).
\textsuperscript{136} See 15 U.S.C. § 77h–1 (2000) (providing the SEC’s authority to review and regulate all
registrations).
The periodic disclosure requirements of the ’34 Act serve a similar purpose, although in a more indirect manner. In order to provide prospective purchasers and sellers with adequate information on which to base their investment decisions, the SEC requires the annual, quarterly, and interim filings under the ’34 Act. Courts have acknowledged that investors use these disclosures to make investment decisions. Although the issuer is not the seller in most transactions that occur based on ’34 Act disclosure, the issuer is aware that purchases and sales are being made in reliance on its disclosures. In addition, because issuers periodically return to the securities markets, the price set by transactions in the secondary market impacts the company itself.

It is true that the SEC could have taken a more intrusive approach by limiting the actual offerings or prohibiting certain types of purchasers, such as those less sophisticated, from participating in offerings. The restriction of speech allows prospective issuers more regulatory flexibility than they would otherwise have, not less. However, the rejection of the Posadas case in 44 Liquormart does not provide the ability to censor speech simply because the speech relates to activities that the government can prohibit. Therefore, the fact that the SEC could act more drastically under its power to regulate commercial activity should not exempt the SEC’s speech regulations from scrutiny under the commercial speech doctrine.

Some commentators have argued that securities are different from other consumer goods. While it is true that a prospective purchaser cannot inspect or consume a security to determine its contents and worth as he would a tangible product, securities are not terribly different from many types of products subject to more traditional advertising that is checked by the First Amendment. Pharmaceutical products, such as the compounded drugs involved in Thompson v. Western States Medical Center, require disclosure to determine their contents. The reliance of the public on disclosures in each of these instances is similar. A share of stock in General Electric or Microsoft does not entitle the holder to the same economic benefits as a share of stock in Enron, and prospective purchasers sort out the distinctions based on disclosures provided initially by the companies. Similarly, a pill for hay fever and a pill for erectile dysfunction may look the same, but their effects on the body are quite different. A patient must trust the disclosure of the drug company to determine which is which.

138. See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988) (recognizing that traders in shares of Basic Inc. “had done so in reliance on the integrity of the price set by the market”).
139. Also, with the adoption of the integrated disclosure system, issuers often use ’34 Act periodic reports as part of the ’33 Act filings. In those instances, the text of the ’34 Act reports will become part of the prospectus used to market those securities sold directly by the issuer.
140. See supra Part II.B.4–5.
B. Investors Need Less Government Protection Than Others

Both the SEC and the Court are concerned about the hearers of information.\textsuperscript{142} The mandatory disclosure regime is in place to protect investors and promote efficiency in markets.\textsuperscript{143} These goals are achieved by getting information to prospective investors in a time and manner that will allow them to make investment decisions, and by prohibiting false or misleading information that would cloud those decisions. The Court is concerned with the dissemination of truthful information and intervenes when government interferes with the consensual sharing of truthful information relating to a product or service.\textsuperscript{144}

At first blush, the concerns of the SEC seem similar to those of the FDA in determining appropriate advertising of new drugs, or those of a state bar association when regulating attorney solicitations. Each body wants to protect its constituency—investors, drug consumers, potential legal clients—from fraud or deception. However, with regard to mandatory disclosures, there is less need for the SEC to be concerned for investors than there is for a consumer protection group to be concerned. The presence and role of sophisticated investors in the market has lead to this lesser need for mandatory disclosures and to less concern that an unsophisticated investor will receive an inadequate price, even if issuers do not make the appropriate disclosures.\textsuperscript{145} These sophisticated investors, for their own selfish interests, make determinations about the value of securities and buy or sell based on these determinations. Because sophisticated investors account for a significant amount of the volume of trades, the equilibrium between sophisticated buyers and sellers often sets the market price.\textsuperscript{146} When individuals invest in the retail market, they receive the benefit of these informed pricing decisions. Recent research into market inefficiencies and irrationality inform this discussion but do not refute its central point.\textsuperscript{147} Courts have broadly acknowledged the functioning

\textsuperscript{142} See, e.g., Neuborne, supra note 31, at 25 (stating that the Court’s commercial speech cases demonstrate that hearers of speech “have an instrumental first amendment interest in receiving information”).

\textsuperscript{143} See Seligman, supra note 41, at 9 (citing five justifications for the mandatory disclosure system: prohibiting issuers from concealing or misrepresenting information, avoiding excessive underwriting costs and insider salaries, improving public confidence in capital markets, compensating for the inability of states or self-regulatory organizations to accomplish these objectives, and combating the ineffectiveness of civil or criminal remedies alone to provide adequate protection to investors).

\textsuperscript{144} See supra Part II.B.


\textsuperscript{146} See, e.g., HOMER KrippE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 84 n.2 (1979) (arguing that studies showing mutual funds do not outperform market averages are of little worth, because they “use services of the same kind of financial Analysts as do other institutions, Institutions are so large a portion of the market that, as a group, they can hardly outperform the market.”).

of this market-pricing mechanism, and the efficient capital markets hypothesis (ECMH) provides it additional theoretical support.

1. Market Pricing in the Courts

While the Supreme Court has not addressed whether SEC disclosures constitute commercial speech, it has assessed the validity of the market pricing mechanism. The decision by the Supreme Court in Basic Inc. v. Levinson\(^\text{148}\) provides the most prominent example of this discussion. In that case, the Court accepted the fraud on the market theory as the basis for allowing a rebuttable presumption of reliance in private rights of action brought under Rule 10b-5 of the ’34 Act.\(^\text{149}\) By accepting this theory, the Court inherently affirmed the contention that unsuspecting investors receive the benefit of decisions made by informed investors.\(^\text{150}\)

The plaintiff class in Basic contended that the company made material misrepresentations by falsely denying the existence of merger negotiations, causing them to sell stock at an artificially low price.\(^\text{151}\) The specific issue in Basic was whether each individual plaintiff had to prove the element of reliance, or whether reliance could be presumed for the entire class.\(^\text{152}\) If the Court required individual proof of reliance, each plaintiff would have to show that he was aware of the company’s false statements and that those statements caused him to take action.\(^\text{153}\) In relying on the fraud on the market theory, the Court held that reliance could be presumed for class certification purposes.\(^\text{154}\)

Allowing this presumption meant the Court had to find that the decisions of informed, sophisticated investors impact the price at which individual, uninformed investors trade.\(^\text{155}\) The Court noted, “The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price,”\(^\text{156}\) and “[i]n an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock, and purchasers generally rely on the price of the stock as a reflection of its value.”\(^\text{157}\) In Basic, this concept is used to show

rereading of regulatory behavior). Nevertheless, Langevoort does not see these inefficiencies as sufficient justifications for rethinking what is one of the principal practical accomplishments of the Efficient Capital Markets Hypothesis (ECMH), the fraud on the market doctrine. Langevoort, supra, at 176.

\(^\text{149}\) Id. at 243–47.
\(^\text{150}\) See id.
\(^\text{151}\) Id. at 228.
\(^\text{152}\) Id. at 230.
\(^\text{153}\) Id. at 242.
\(^\text{154}\) Id. at 247. Also, Basic upheld the materiality standard set forth in TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976), and applied it to mergers. Basic, 485 U.S. at 232. For our purposes, the significant holding of Basic relates to the presumption of reliance. See id. at 242–45.
\(^\text{155}\) See id. at 244–47.
\(^\text{156}\) Id. at 244 (quoting In re LTV Sec. Litig., 88 F.R.D. 134, 143 (N.D. Tex. 1980)).
\(^\text{157}\) Id. (quoting Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986)).
how investors can be hurt, even if they do not receive and act on publicly disseminated information.\textsuperscript{158} In the same manner, the informed decisions of sophisticated investors protect other investors in a way not available to consumers of regular commercial goods, where the commercial speech doctrine already applies.

2. Efficiency in Capital Markets

The ECMH\textsuperscript{159} lends additional support to the claim that investors need less protection than the general public. The ECMH states that information is reflected in stock prices.\textsuperscript{160} This theory describes a process whereby investors process information so that it will be reflected rapidly and accurately in the price of a security.\textsuperscript{161} The well-developed capital markets in the United States are examples of what scholars consider to be efficient markets in action.\textsuperscript{162} A rational investor in such a market will continue to seek out information until the cost of doing so exceeds the value he would receive from additional information.

The implications of the ECMH for speech regulation are twofold. First, there is some question of the need to require issuers to provide disclosure at all.\textsuperscript{163} If rational investors will seek out information that produces economic benefit, the mandatory nature of these disclosures is questionable. Proponents of mandatory disclosure point to fairness concerns, such as whether all market participants will have equal access to important information under a voluntary regime, and to market integrity issues—a market where certain basic information on issuers and offerings is not required to be available is more susceptible to abuse and fraud.\textsuperscript{164} These arguments provide serious support for retaining the mandatory disclosure regime, but they do not take away from the fact that the rational, information-seeking behavior of market participants lessens the urgency for SEC speech protections.

There is another aspect of the ECMH and its outgrowths that make it even less pressing for the government to regulate securities speech: it provides theoretical

\textsuperscript{158} See id. at 246–49.
\textsuperscript{159} There are three forms of the ECMH: the weak form, which claims that past price information is incorporated into current stock prices; the semi-strong form, which claims that all public information is incorporated into current stock prices; and the strong form, which claims that all information, even non-public information, is incorporated into stock prices. Michael S. Knoll, Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment, 57 BUS. LAW. 681, 693 n.88 (2002). When referring to the ECMH, this Article will concentrate on the semi-strong form—claiming that all publicly available information is rapidly assimilated into stock prices.
\textsuperscript{160} See Gilson & Kraakman, supra note 145, at 568–72.
\textsuperscript{161} Id.
\textsuperscript{163} See generally Easterbrook & Fischel, supra note 8 (discussing the functions of legal rules mandating disclosure and the implications of alternative methods of controlling market prices).
\textsuperscript{164} See Pinto, supra note 141, at 83 (suggesting that there is a greater potential for fraud in the securities market, where participants are highly dependent on the seller for information).
support for the market pricing mechanism, allowing even those investors who are completely ignorant to receive the benefit of the collective insights of market participants.\textsuperscript{165} If an investor wants to buy one share of Microsoft stock without knowing anything about the company, the theory of the mandatory disclosure regime suggests he would be in grave danger. Many disclosures are necessary in order to understand Microsoft's business, the particular characteristics of the security the investor is about to purchase, and the main factors that Microsoft believes will drive its business into the future. In fact, if the prospective purchaser were in a bazaar bargaining for a share of stock, all of these matters would be of critical importance. However, this investor will not need to bargain over price, nor will he be allowed to bargain in any meaningful way. The price will be set by the market. Many buyers and sellers congregate, some owning stock and willing to sell, others eager to buy. The collective data, experience, and insight of the group will set the market price.\textsuperscript{166} Anyone who wants to buy shares will get the benefit of this price, even if the purchaser knows nothing about the company itself. He will be able to free ride on the research, expertise, and insights of the many market participants when making a purchase.

This benefit is significant and not available with regard to other product advertising. Often the same item sells for different prices at different locations. There is no single market clearinghouse to determine if the goods or services offered are of sufficient interest or quality to generate a substantial demand. All of these things are present in the national securities markets. This advantage makes the additional prohibition of speech less necessary in the securities area than in other advertising.

One recent area of inquiry in the finance field is the validity and legitimacy of the ECMH and its implications for markets. These studies have found significant events and market trends that do not conform to the efficient model.\textsuperscript{167} There are two primary explanations that each have some support: there is "noise" in the market, randomly and unexpectedly creating inefficiency, and there are behavioral explanations that can predict market behavior better than pure assumptions of rationality.\textsuperscript{168} These studies argue against a blind faith in the rationality of markets. However, they do not refute the central point that there are structural benefits of securities markets, such as the pricing mechanism and rational investor behavior, even if they do not always act rationally, that benefit market participants in ways that are unavailable to those who are consumers in the markets where advertiser

\textsuperscript{165} Neuborne, supra note 31, at 55 (describing capital markets as "highly sophisticated information processing machines that rapidly assimilate data to price stock through efforts of market professionals").

\textsuperscript{166} See id.


\textsuperscript{168} See Langevoort, supra note 147, at 137.
speech is protected under the commercial speech doctrine.\textsuperscript{169}

C. Arguments for Heightened Protection of SEC Disclosures Remain Unpersuasive

Another question, one that many of the earlier commentators addressed, is whether securities regulation deserves even more protection than that given to commercial speech. One argument for extending this fuller protection is that federal securities law is focused on the content of speech. At the core of many disclosure requirements is the concept of materiality; issuers must disclose material events, but disclosure might not be required if the event is immaterial to the company. This focus on materiality is a type of content regulation.\textsuperscript{170} Content regulation has been traditionally looked upon skeptically by the Court, having to withstand a higher level of First Amendment scrutiny.\textsuperscript{171}

This call for higher scrutiny of the entire regime is unrealistic and misguided. First, is unrealistic because the Court has never acknowledged that SEC disclosures are speech at all. Until the Court is willing to show the interest in making the small and logical step from mandatory disclosures to commercial speech, it is not likely to provide higher levels of protection. Second, the call for higher scrutiny is misguided because commercial speech jurisprudence has grown from a different set of concerns than the traditionally protected areas of speech, such as political, religious, or expressive communication.\textsuperscript{172} The differences in rationale for protection make the analysis of SEC disclosure more similar to the commercial speech cases. The corporate speaker rarely has a speech interest as such in the disclosures it makes. The public interest in protecting this speech relies solely on benefits it confers on the hearers of speech. This context aligns with advertising, not with speaker-centered arenas such as political or artistic expression. In those areas, the rationale for protection is distinct; for example, there is a significant First Amendment interest in protecting even false, harmful, or misleading speech.\textsuperscript{173} No such concerns exist with regard to SEC disclosures.

Commentators have argued for different levels of scrutiny for several particular types of SEC disclosure, analogizing each type to categories of speech that receive

\textsuperscript{169} See, e.g., Stephen M. Bainbridge, Mandatory Disclosure: A Behavioral Analysis, 68 U. Cin. L. Rev. 1023, 1024 (2000) ("Although some scholars argued market forces will produce optimal levels of disclosure in a regime of voluntary disclosure, while others argued that various market failures necessitate a mandatory disclosure system, all shared certain basic assumptions, of which a strong form of rational choice theory is the most important for our purposes.").

\textsuperscript{170} Schauer, supra note 71, at 1778.


\textsuperscript{172} See Neuborne, supra note 31, at 17; Sullivan, supra note 116, at 127–29.

\textsuperscript{173} See, e.g., Nat'l Socialist Party v. Vill. of Skokie, 432 U.S. 43, 43–44 (1977) (per curiam) (involving the protection of speech inherent in certain types of political demonstrations).
full First Amendment protection. A common call is for heightened review of proxy speech. Proxy disclosure presents an appealing example because proxy disclosures look like political speech. Proxy disclosures may involve elections of directors, votes at a shareholders meeting on topics of interest to the company, and, sometimes, competing factions. Commentators have noticed this resemblance and have argued for greater protection for this type of speech that is more than just proposing a transaction.

It is true that proxy speech is not directly related to the purchase or sale of a security but is a type of hybrid speech. Unfortunately, there are significant deficiencies in the analogy to political elections, and it is not clear how this hybrid disclosure should be treated. Proxy materials are not the speech of the corporation itself. They are the speech of various claimants who wish to direct the resources of the corporate whole. When management publishes its proxy statement using company resources, it is an attempt by one stakeholder in the company to convince other stakeholders of its position on issues.

The idea that the company itself is not speaking through the proxy materials also lessens the connection to advertising, the traditional form of commercial speech. In advertising, the seller is directly addressing prospective purchasers. In a proxy statement, one stakeholder of the “seller,” its management and incumbent board, addresses other stakeholders. Thus, the seller’s relationship to the prospective purchasers is at least one step removed. The advertising analogy similarly fails when examining other SEC-mandated speech by parties other than issuers. Proxy solicitation, investment advisor regulation, beneficial ownership reporting, and regulation of investment newsletters each raise significant speech issues. These are also issues that have initially caught the attention of courts; however, the commercial speech doctrine is less suited to resolve them.

While proxy speech and other disclosures relating to market participants other than issuers raise complex, unresolved speech issues, SEC disclosure regulation of...
the issuers themselves poses no such problems. Particularly, the periodic reporting requirements of the ‘34 Act and the registration process of the ‘33 Act are examples of commercial speech and can be analyzed according to that relatively well-defined set of rules. Because of the concerns expressed by the Court in its commercial speech jurisprudence, it is most fruitful to look at these securities regulations as those that prohibit an issuer from making a certain type of disclosure, those that require disclosures, and those that condition disclosures on issuers taking additional action.

IV. Analysis of Current SEC Rules Under Commercial Speech Doctrine

If we persuade the Court to turn its attention to the field of securities regulation, what is it likely to find? This part discusses the application of the current Court’s commercial speech doctrine to SEC regulation. Analyzing the commercial speech

179. Another example of non-issuer speech regulated by the SEC involves the regulation of investment advisers’ distribution of newsletters and similar publications. The Court has provided some protection to these parties. See generally Boyer, supra note 42, at 480 (“Lowe represents the high-water mark of commercial speech protection in the securities area. Its outcome, however, is a familiar one: direct solicitations may be regulated in order to protect the public, but the law will protect the dissemination of general information.”); Ribstein, supra note 38, at 127-29 (claiming Belotti, Wall Street Publishing, Lowe, and Long Island Lighting Co. v. Barbash, 779 F.3d 793 (2d Cir. 1985) “suggest that the application of the First Amendment to corporate speech is very much an open question”).

180. Treating SEC disclosures as commercial speech could lead the Court to invalidate the entire mandatory disclosure regime. The two arguments against the regime itself are that, simply applying Central Hudson, the regime does not directly advance the state interest involved, and the government interest can be served just as well by a more limited restriction. If the regime is admittedly burdensome, and there is evidence to suggest that some or all of the required disclosures would be publicized absent any compulsion whatsoever, is the SEC’s entire regulatory scheme a poor fit? Does it fail the third or fourth prongs of the Central Hudson test?

There are two arguments that ought to prevail over this attack to the entire edifice of federal securities law. First, Central Hudson does not require a perfect match, only a reasonable one tailored to the goal. Congress, aware of the wide variety of state law practices in effect prior to the ‘33 Act, decided to use the less burdensome disclosure approach. Also, substantial evidence suggests that the securities laws advance Congress’s stated goals. See Black, supra note 167, at 831-38; Coffee, supra note 8, at 735-36, 751-52. Second, the policy arguments asserting the failure of the regime as a whole are not settled. Researchers continue to review the need for mandatory disclosure, whether efficiency effectively protects the unsophisticated and unwary, and the degree to which market participants behave rationally. For a recent survey, see John Y. Campbell, Asset Pricing at the Millennium, 55 J. FIN. 1515 (2000).

We should not lightly overthrow an entire regulatory structure, and certainly not over debated and disputed conclusions of research that continue to raise questions and objections. The United States Court of Appeals for the District of Columbia has indicated that this assessment of the entire mandatory disclosure system may be the end of the inquiry. In SEC v. Wall Street Publishing Institute Inc., 851 F.2d 365, 373 (D.C. Cir. 1988), the court of appeals stated, “In areas of extensive federal regulation—like securities dealing—we do not believe the Constitution requires the judiciary to weigh the relative merits of particular regulatory objectives that impinge upon communications occurring within the umbrella of an overall regulatory scheme.” However, this statement was made when Posadas was still good law, and before the expansion of the commercial speech doctrine, particularly before the Court decided Thompson v. Western States Medical Center, 535 U.S. 357 (2002). See supra Part II.B.
ideas that (i) false or misleading speech is not protected; (ii) simply mandating disclosures is often consistent with the First Amendment; (iii) conditions on speech must be narrowly tailored to fit the regulatory purpose; and (iv) suppression of truthful information based on paternalistic concern is viewed skeptically, this part examines SEC regulations of three different sorts: those that flatly prohibit certain types of speech, those that mandate disclosure, and those that condition disclosure on other speech or action.

A. Regulations that Forbid the Prohibition of Truthful, Nonmisleading Speech

If the courts ever were to consider securities regulations to be commercial speech, SEC rules that prohibit the dissemination of truthful information ought not withstand any serious scrutiny. The commercial speech cases do not allow a paternalistic concern for whether hearers can handle truthful information to serve as the basis for prohibition of this type of speech. 181 Also, the Supreme Court has noted that “[d]isclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress” in enacting the federal securities laws. 182 This combination of authority puts SEC regulations forbidding accurate speech on very weak footing. Examples of these types of regulations are the rules relating to the offering of securities, such as the “gun jumping” rules, and the recent prohibition of certain non-Generally Accepted Accounting Principles (GAAP) measures in SEC documents.

The prohibitions surrounding the offer and sale of securities are the clearest examples of First Amendment violations. 183 The SEC interprets the ’33 Act to prohibit a broad range of corporate communications during the time period between the filing of a registration statement and the time it is declared effective by the SEC. 184 The Commission imposes this “quiet period” on the premise that information not contained in the prospectus, regardless of its truthfulness, could

The repudiation of Posadas and the forceful protection of commercial speech in the last decade, particularly the invalidation of FDA speech prohibitions in Thompson, should cause the Court to reassess this perspective.


183. See Estreicher, supra note 36, at 289–91 (“By withholding from the public at [an] initial stage relevant, truthful information about particular offerings, the state imposes costs on investors who may needlessly expend time and effort investigating offerings that do not meet their needs.”); Ribstein, supra note 38, at 136–37 (asserting, under the contract theory of corporate speech, that “[a]ssuming the speech regulated by the 1933 Act should be given no more protection than ordinary commercial speech, some aspects of mandatory prospectus regulation under federal and state law raise serious concerns under the First Amendment. . . . [T]he possibility that requiring delivery of prospectuses will prevent some people from making bad investments is outweighed by the large costs imposed on issuers and on the market.”).

“condition the market” and mislead investors. Officers of the company are cautioned by counsel not to hold press conferences, give interviews, or even alert the public that an offering is about to occur. Recent SEC rulemaking lightens this burden for some of the largest issuers, but not for most others.

This speech is in fact the closest SEC disclosures come to traditional advertising—what has been recognized in other contexts as commercial speech—as it alerts the market to a new product—an offering of securities—that market participants may want to purchase. However, it remains one of the most pervasive areas of SEC regulation. In fact, a seminal case in the area found an issuer liable for issuing a press release stating that the issuer owned land in the Florida Gold Coast (true), claiming it was about to go public (true), and naming (accurately) the investment banker who would be handling the underwriting.

The recent prohibition on non-GAAP measures is similarly troubling under a commercial speech analysis. As part of the extensive rulemaking following the Sarbanes-Oxley Act of 2002, the SEC promulgated a rule that addressed various types of use of non-GAAP financial information. Part of this rule prohibits...
certain types of information from use in SEC filings. For example, companies are not allowed to exclude charges or liabilities that require cash settlement from non-GAAP liquidity measures. Companies also cannot eliminate charges as non-recurring, infrequent, or unusual if those charges have occurred within the last two years or are reasonably likely to reoccur within the next two years. The prohibition is not limited to situations where the use of these figures will be misleading. It applies regardless of the value or truthfulness of the information.

The first reason that these two regulations should be struck down is the line of precedent disapproving of the suppression of truthful speech. As in those cases, the Court is unlikely to approve of the reasoning that investors should not be provided with accurate information because a government regulator is concerned that they will not be able to process it adequately. In addition, under Central Hudson, the SEC will be unable to demonstrate that it could not achieve its goals by less intrusive means. The primary concern in both the securities advertising and non-GAAP situations is that the mere existence of this type of truthful information, along with other required disclosure, has the potential to mislead investors. However, as seen in the non-GAAP regulations themselves, the SEC has other means available to ensure that truthful information does not mislead. For example, requiring additional disclosure or explanatory statements could lessen the possibility of misleading investors. Enforcement of violations could also reduce the impact. These combined methods provide powerful protections in other areas, and no reason exists to think they would not be effective here.

One powerful argument in favor of the SEC’s ability to regulate in this manner is that the SEC is best suited to assess the facts and should be granted deference in determining how to best keep false and misleading information out of the hands of investors. Courts are typically, and properly, hesitant to interfere with or overturn the judgment of regulatory agencies with subject matter expertise and experience.

companies.” Id.
192. See supra Part II.B. for a discussion of this line of cases.
194. See, e.g., Carl M. Loeb, Rhodes & Co., supra note 188, at *6. (containing provisions requiring additional disclosures when non-GAAP measures are used in different circumstances). Additional disclosure, providing comparable GAAP measures and a quantitative reconciliation between the GAAP and non-GAAP measures, is a less burdensome alternative than prohibition of this data altogether.
195. See Dooley, supra note 38, at 342–43 (“The initial part of the government’s case is very easy to argue. The government has an undeniable interest in the nation’s capital markets, and the disclosure provisions are designed to enhance the efficiency of such markets by reducing investors’ information costs . . . But the government need not overstate its case in order to justify the disclosure system. It is enough if the government can frame a plausible argument that mandatory disclosure produces some important information that would not be consistently disclosed on a voluntary basis.”).
196. Boyer, supra note 42, at 485 (“Because requiring disclosure is less restrictive than banning speech, O’Brien and Zauderer, when read together, suggest that a communicative act can be regulated—and in the case of securities disclosure, required—on the basis of the non-communicative conduct that it entails.”); Dooley, supra note 38, at 336 (“[G]iven the serious separation of powers

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Making these difficult balancing judgments is often better left to policymakers than to courts. 197 The Supreme Court has even noted that a governmental entity may place appropriate restrictions on speech that is only potentially misleading. 198

However, in this instance, two important factors temper the presumption in favor of the SEC. First, the Court has upheld challenges to other speech prohibitions where the agency’s authority stemmed from the bald assertion of its necessity for preventing public confusion or misunderstanding. 199 The ability to prohibit potentially misleading speech is limited to those restrictions that are reasonably necessary to prevent deception. 200 Second, in assessing reasonableness, the SEC does not exactly have the best record in determining when to prohibit truthful speech. 201 The key example of this is the SEC changing its position regarding the use of projections.

For decades, the SEC prohibited the use of projections in disclosure documents. 202 It determined that this “soft” information was easily manipulated and would be confusing for investors. 203 Thus, investors should only be given the factual, historical information on which to base their investing decisions. Then, with the acceptance of the discounted cash flow model in finance theory and related developments, 204 investors came more and more to value forward looking information. Because the value of a security to investors depended on future production of revenue and income, historical information was only of value to the extent it could predict future performance. The ban on discussing prospects hindered investors from receiving the very information they deemed most valuable.

The SEC’s response to investors’ changing values might be an example of a flexible regulatory regime changing with the times, but a detailed look at the history is less charitable to the institution. 205 An article appeared as early as 1961

issues inherent in judicial review of economic regulation, it may be safe bet to that the Court eventually will hold that corporate disclosure is not commercial speech . . . ”).

197. Pinto, supra note 141, at 98–99 (citing Bangor & Aroostook R.R. v. Interstate Commerce Comm’n, 574 F.2d 1096, 1107 (1978)).


199. Id. at 203–04.


201. One scholar notes, [T]he [SEC] has used a radical prophylactic approach to speech—banning all speech that might be harmful to someone, some day. The classic SEC approach applies an interlocking set of prior restraints and restrictions on the form and timing of speech to minimize the possibility of harmful speech, despite its concededly restrictive effect on much speech that would be of use to hearers.

Neuborne, supra note 31, at 51.


203. For a detailed discussion of how the SEC practice of prohibiting projections frustrated its own goal of accuracy enhancement, see id. at 777–88.

204. See id. at 831–32.

205. See id. at 777.
questioning the prohibition,206 and the SEC itself raised the question in 1969.207 The SEC first held hearings on the matter in 1972,208 issued a release announcing its conclusions in 1973,209 and proposed relevant regulations in 1975.210 These regulations were burdensome on companies wishing to voluntarily disclose projections and were never adopted.211 The SEC re-assessed its rules and ultimately adopted a limited safe harbor for projections in 1979, ten years after the matter was first formally studied.212

This history with projections shows a reluctant regulator who only grudgingly allowed speech that should have been encouraged decades earlier. In fact, it appears that we may be on the verge of a similar shift regarding advertising of securities offerings. This shift began in 1998 with the proposal of a '33 Act reform, commonly known as the “aircraft carrier release,” seeking enormous changes.213 One aspect of these proposals was to lessen some of the restrictions on the ability of issuers to communicate before and during the offering of securities.214 Although never adopted, in June of 2005 the SEC did adopt similar rules, at least with regard to the speech restrictions surrounding offerings.215 This reform provides some issuers partial relief from the most burdensome of restrictions, but it still imposes some or all of its prohibitions on at least some category of issuers.216 It is an incremental step that does not diminish the constitutional case against these prohibitions of truthful speech. If anything, it provides additional evidence that, given enough time and experience, even the most firmly held belief by the

211. See Kitc, supra note 65, at 780–85.
214. Id. at 81,469.
SEC—that truthful speech is harmful or misleading—will be proven incorrect.

B. Upholding Regulations Simply Requiring Disclosure

The second type of SEC regulation, that which requires disclosure of certain types of information, is the most common type of SEC regulation. This type of regulation is not problematic from a commercial speech perspective. The Court has acknowledged that it is appropriate for regulators to require the provision of certain types of information that it deems to be important. In Zauderer v. Office of Disciplinary Counsel, the Court noted that a person’s constitutionally protected interest in not providing any particular factual information in his advertising is minimal. Thus, in virtually all our commercial speech decisions to date, we have emphasized that because disclosure requirements trench much more narrowly on an advertiser’s interests than do flat prohibitions on speech, “warning[s] or disclaimer[s] might be appropriately required . . . in order to dissipate the possibility of consumer confusion or deception.”

While the Zauderer Court addressed a narrower set of requirements, the holding is consistent with the theory of full and broad dissemination of information that underpins the Court’s commercial speech decisions.

SEC disclosure presents an additional layer of concern that is not present in general commercial advertising. SEC disclosures are not only required, but the securities laws subject the issuer-speaker to liability, in some cases strict liability, for false or misleading statements made in those mandatory disclosures. The imposition of liability in this circumstance can, and evidence suggests that it often does, limit the willingness of an issuer to discuss matters of importance. The potential chilling effect of this liability ought to be taken into account.

Even with this additional concern, courts should uphold regulations simply mandating disclosure. The commercial speech jurisprudence does not protect false and misleading speech. If there is some possibility that the regulation of unprotected speech will impact protected speech, that regulation should be assessed

217. Neuborne, supra note 31, at 41 (claiming that there is no serious First Amendment objection to mandatory disclosure if that disclosure preserves the hearer’s capacity for informed choice).
218. Estreicher, supra note 36, at 286-87 (“When the SEC compels issuers to comply with disclosure requirements, it is, in a sense, insisting on the provision of the equivalent to up-to-date product information [of product labels]. The SEC is attempting to prevent fraud and to ensure full and accurate disclosure concerning the real-world enterprise a securities offering represents.”).
220. Id. at 651 (quoting In re R.M.J., 455 U.S. 191, 201 (1982)) (emphasis omitted).
221. See supra notes 44–60 and accompanying text.
222. For a more detailed discussion of this assertion, see Kitch, supra note 65, at 770–72.
under *Central Hudson*. In the case of securities regulations, the remedy of punishing false or misleading disclosure seems directly related to the goal of providing complete and accurate information to potential investors, and the fit is a good one. There are more draconian methods available to, and used by, the SEC to avoid false or misleading statements, such as prior restraint of publication. The sanction directly relates to the interest sought to be protected. Based on these factors, SEC rules requiring disclosures should be upheld under a *Central Hudson* analysis, even though they may have a chilling effect on some protected speech.

C. *Seriously Review Regulations that Condition Speech*

Other regulations involve more than simple disclosure requirements and place limitations on speech until or unless certain conditions are met. This type of regulation is the most difficult to assess and the least susceptible to an easy First Amendment analysis. An example of this type of regulation is the recently promulgated Regulation FD.\(^\text{224}\) FD stands for Fair Disclosure, and the regulation is the SEC’s attempt to prohibit the selective disclosure of material nonpublic information. In essence, it prohibits an issuer from disclosing this information privately, so that an issuer wishing to make such a disclosure must make the information publicly available.\(^\text{225}\)

The regulation does not expressly prohibit an issuer from making any truthful statements. Its terms only require that a private statement be simultaneously announced to the public by means of a broad dissemination.\(^\text{226}\) However, this regulation has had limiting effects on speech in at least two demonstrable ways. First, an issuer is not always ready or willing to discuss matters publicly, even if the issuer is willing to discuss them privately. This hesitation leads to a reduction in the overall flow of information from a company in order to time disclosures to public needs. Second, when private discussions are held, issuers, wary of SEC enforcement, have set up ground rules that prohibit them from discussing matters that are likely allowed under the rules but lie in an area of uncertainty.\(^\text{227}\) These meetings with analysts and other market professionals are less candid and productive and reduce the amount and quality of truthful information in the market.

Under *Central Hudson*, this type of regulation is only permissible if the


\(^{225}\) Id. § 243.100(a).

\(^{226}\) Id.

regulation is narrowly tailored to meet the stated goals. Regulation FD has two purposes: to ensure the integrity of markets by preventing selective disclosure, and to more rapidly disseminate information to the public. Regulation FD, almost by definition, advances the goal of preventing selective disclosure. The difficult aspect of the analysis concerns the ability of the SEC to accomplish its goal by less restrictive means. When promulgating new regulations, the SEC is required to undertake and describe a lengthy cost-benefit analysis. This analysis for Regulation FD, as well as for other regulations, does not take into account the speech-based concerns that are the focus of this Article. In fact, no published study has quantified the impact of Regulation FD on the volume or quality of issuer speech.

The invalidation of a rule or statute should only be done with ample care, and any party seeking the invalidation of Regulation FD on First Amendment grounds should be required to provide some empirical support for that position. Nevertheless, there are significant theoretical concerns with the SEC’s approach. First, there is some evidence that privately communicated information does make its way rapidly into the market. In fact, a review of the enforcement actions in this area shows that the prompt or immediate dissemination of the private communication is the trigger for opening the SEC investigation.

This fact leaves the impression that the true concern Regulation FD addresses is not that the information will not make it to the market promptly, but that some will have it before others and use it to their advantage. In other words, it is a matter of market integrity, not efficiency. However, the market integrity rationale is severely limited by the fact that insider trading law, an existing enforcement mechanism, could be used to police infractions. If a party with knowledge passes

228. *Central Hudson*, 447 U.S. at 566.
230. See id. at 51,731–33.
232. Interestingly, one party has brought an action against the SEC to invalidate Regulation FD on First Amendment grounds, among others. The First Amendment objection is based on a claim of content regulation, not a violation of commercial speech protections. See Memorandum of Points and Authorities in Support of Defendants’ Motion to Dismiss the Complaint, *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694 (S.D.N.Y. 2005) (No. 04 CV 05130), 2004 WL 3142264.
234. See supra note 226.
it on to another, and that party trades on the material, nonpublic information, both the tipper and tippee may be prosecuted under federal laws on the books at the time Regulation FD was passed.²³⁵ There is no evidence that this mechanism of enforcement has proven ineffective or that the SEC seriously considered it as an alternative in promulgating Regulation FD. If a litigant can provide courts with the empirical evidence that Regulation FD stifles a substantial amount of truthful speech by issuers, the courts should give serious consideration to whether it should strike down the regulation as an unlawful prohibition of commercial speech under the First Amendment.²³⁶

V. CONCLUSION

Since it first provided protection to commercial speech in 1976, the Supreme Court has announced a test for scrutinizing regulations that impinge upon speech, provided a rationale for protecting the interests of the distribution of truthful information, and not concerned itself with whether other regulatory agencies have interests in the field. It has also recently indicated an interest in exploring the expansion of commercial speech protections beyond simple product advertising.

Despite all of these developments, no commercial speech challenge to federal securities regulation has been successful, or even seriously attempted, in recent years. Because of the similarity of securities disclosure to advertising, the additional protection the market brings to investors, and the willingness of the Court to address even heavily regulated industries, securities regulation should be an attractive field for the application of the commercial speech doctrine. If federal securities regulation is considered to be commercial speech, courts will strike down the regulations’ prohibitions on the dissemination of truthful information, will heavily scrutinize the more burdensome regulations, and the bulk of the regulations will remain in place, providing ample protection for investors.
