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Taking Stock of the First Amendment's Application to Securities Regulation

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TAKING STOCK OF THE FIRST AMENDMENT'S APPLICATION TO SECURITIES REGULATION

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I. INTRODUCTION

More than seventy years ago, Congress passed the first of the federal securities laws, the 1933 Securities Act, which was quickly followed by the 1934 Securities Exchange Act and several others. These Acts, along with more recent additions like the Williams Act and the Securities and Exchange Commission's regulations, compel disclosures, such as a corporation's financial condition, and restrict speech, such as unapproved proxy solicitations.[1]

When Congress passed these early laws, the First Amendment was thought

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1. *See infra* Part III.

to be irrelevant to securities regulation because the Supreme Court had not yet extended First Amendment coverage to government-compelled speech or commercial speech. These later extensions of coverage posed a difficult question regarding whether the First Amendment should also cover the speech affected by securities regulation.[2] The Supreme Court, however, has so far managed to avoid directly resolving the issue.[3]

An impressive list of commentators has argued against the application of the First Amendment to securities regulation.[4] Some argued that the courts had already foreclosed the application of the First Amendment to securities regulation.[5] Other arguments attempted to distinguish the speech covered by securities regulation from more protected speech, or the subject matter of

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2. "Speech affected by securities regulation" is a rather awkward way of expressing the subject matter. It refers to the communication that may be mandated, prohibited, or simply chilled by securities regulators. In the United States, the principal securities regulator, of course, is the Securities and Exchange Commission, and the federal legislation is contained in the federal securities acts. Also, it is worth noting that speech requirements or restrictions imposed by private self-regulating organizations such as the National Association of Securities Dealers (NASD) or the New York Stock Exchange (NYSE) are untouched by the First Amendment so long as there is no state action. Recent claims that the actions of these self-regulatory organizations should be attributed to the state have been rejected. *See* Steven J. Cleveland, *The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations*, 55 AM. U. L. REV. 1, 21–22, n.119 (2005) (listing cases). This has not prevented some lawyers from objecting to proposed NYSE rules on First Amendment grounds. *See* Jonathan D. Glater & Landon Thomas, Jr., *Proposed Rules for Analysts Raise the Ire of Publications*, N.Y. TIMES, Nov. 23, 2002, at C1 (reporting on periodicals' objections to a proposed rule that would in some circumstances prevent analysts from speaking to journalists). More recently, however, the Court has allowed even a state actor to restrict the First Amendment rights of those who are voluntarily members. *See* Tenn. Secondary School Athletic Ass'n v. Brentwood Academy, 127 S. Ct. 2489, 2495 (2007), *available at* 2007 WL 1773196.

3. *See* Nike, Inc. v. Kasky, 539 U.S. 654, 655 (2003) (per curiam) (dismissing certiorari as improvidently granted in a case that might have resolved tension between the First Amendment and corporate speech); Lowe v. SEC, 472 U.S. 181, 211 (1985) (resolving a challenge to the Investment Advisers Act of 1940 based on narrow statutory interpretation rather than constitutional grounds); *see also* Michael R. Siebecker, *Corporate Speech, Securities Regulation, and an Institutional Approach to the First Amendment*, 58 WM. & MARY L. REV. 613, 616 (2006) (arguing that securities regulation would be the "track" for an impending First Amendment "jurisprudential train wreck"); James C. Goodale, *The First Amendment and Securities Act: A Collision Course?*, N.Y.L.J., Apr. 8, 1983, at 1 (describing the First Amendment and securities regulation as on a "collision course").

4. *See* sources cited *infra* note 114.

5. *See infra* Part II.B. Frederick Schauer, for example, claims that securities regulation that affects speech is outside the reach of the First Amendment. "The First Amendment just does not show up." Frederick Schauer, *The Boundaries of the First Amendment: A Preliminary Exploration of Constitutional Salience*, 117 HARV. L. REV. 1765, 1769, 1777–79 (2004). There is no independent "First Amendment-generated level of scrutiny." *Id.* at 1770. *See generally* FREDERICK SCHAUER, FREE SPEECH: A PHILOSOPHICAL ENQUIRY 89–92 (1982) (contrasting coverage of a right and protection of that right). Put somewhat differently, the First Amendment might be applicable to securities regulation, but the level of review would be no higher than that extended to any commercial regulation—rational review—and thus the First Amendment's application would be functionally meaningless. Speech affected by securities regulation would be like obscenity or defamation, a category of speech that can be regulated because of its content, not a "categor[y] of speech entirely invisible to the Constitution." R.A.V. v. City of St. Paul, 505 U.S. 377, 383 (1992) (explaining that its statement that obscenity is not a category of expression "within the area of constitutionally protected speech" is not "literally true").

securities regulation—securities and capital markets—from other products and markets enjoying First Amendment protection.[6]

The analysis of the First Amendment's application to securities regulation is difficult in part due to the wide range of speech and speakers affected by securities regulation.[7] Potential speakers include issuers, journalists, shareholders, employees, investment advisors, and even investors themselves. The type of speech that securities regulation can affect is similarly wide ranging. Advertising in the context of a securities offering would appear to fit even the narrowest definition of commercial speech. In contrast, the numbers on a balance sheet are much more debatable. A corporation's comments on issues of public concern—BP on global warning, Nike on sweatshop labor, Ford on environmental protection—appear to be much more like political speech.[8] Another difficulty in this analysis lies in the highly contested nature of the commercial speech doctrine itself[9] and the wide range of viewpoints on the First

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6. *See infra* Parts IV.A & B.

7. *See infra* Part III.

8. For the purposes of this article it is unnecessary to resolve the definitional uncertainty between commercial and higher value speech. *See infra* notes 33–39 and accompanying text. If the speech affected by securities regulation is either commercial or political speech, a justification is needed if the First Amendment is to be inapplicable. For an argument that the speech affected by securities regulation is indistinguishable from high value speech, see NICHOLAS WOLFSON, CORPORATE FIRST AMENDMENT RIGHTS AND THE SEC (1990), and Nicholas Wolfson, *The First Amendment and the SEC*, 20 CONN. L. REV. 265 (1988).

9. Some have argued that commercial speech should not be covered at all by the First Amendment. *See, e.g.*, Lillian R. BeVier, *The First Amendment and Political Speech: An Inquiry into the Substance and Limits of the Principle*, 30 STAN. L. REV. 299, 353 (1978) (arguing that the "proposals of commercial transactions . . . is totally irrelevant to First Amendment values); Thomas H. Jackson & John Calvin Jeffries, Jr., *Commercial Speech: Economic Due Process and the First Amendment*, 65 VA. L. REV. 1, 14 (1979) (asserting that "the concept of a first amendment right of personal autonomy in matters of belief and expression stops short of a seller hawking his wares"); *see also* Vincent Blasi, *The Pathological Perspective and the First Amendment*, 85 COLUM. L. REV. 449, 476–80 (1985) (arguing for a confined ambit of First Amendment protection to ensure that it will function effectively when most needed); Richard A. Posner, *Free Speech in an Economic Perspective*, 20 SUFFOLK U. L. REV. 1, 39 (1986) (noting that it is possible that commercial advertising should receive no constitutional protection); Frederick Schauer, *Commercial Speech and the Architecture of the First Amendment*, 56 U. CIN. L. REV. 1181, 1183–87 (1988) (expressing the opinion that "commercial speech is located at least some distance from the core or cores of the First Amendment") (internal quotation marks omitted). Others contend that commercial speech deserves greater than intermediate-level protection, perhaps because such communication may be highly valued by the recipients or because they believe there is no principled distinction between at least some kinds of commercial speech and core protected speech. *See, e.g.*, Deborah J. La Fetra, *Kick It Up a Notch: First Amendment Protection for Commercial Speech*, 54 CASE W. RES. L. REV. 1205, 1207 (2004); Alex Kozinski & Stuart Banner, *Who's Afraid of Commercial Speech?*, 76 VA. L. REV. 627, 630 (1990); Martin H. Redish & Howard M. Wasserman, *What's Good for General Motors: Corporate Speech and the Theory of Free Expression*, 66 GEO. WASH. L. REV. 235, 237–38 (1998). It is also important that commercial speech and corporate speech are not synonymous. An obvious difference is that commercial speech may be spoken by other business forms, such as partnerships or sole proprietorships. Further, not all corporate speech is commercial speech. *See infra* notes 35–38 and accompanying text.

Amendment's nature, purpose, and function.[10]

This Article will not address the merits of existing commercial speech jurisprudence. Rather, this Article will respond to those commentators who argue that even with the current commercial speech doctrine, the First Amendment should not apply to securities regulation.[11] In other words, given the Supreme Court's commercial speech doctrine—the world as it is—are there reasons that would justify an exemption from the First Amendment for securities regulations affecting speech?

The Article proceeds as follows. Part II briefly examines the recent evolution of the Supreme Court's approach to commercial speech and the relatively few cases in which courts have applied the First Amendment to securities regulation. It also addresses the common argument that the Supreme Court has already effectively foreclosed the First Amendment's application to securities regulation. Part III provides an overview, with examples, of how federal securities regulation affects speech. Although securities regulation focuses primarily on mandatory disclosure, a considerable portion also restricts or burdens disclosure. Part IV evaluates justifications for a securities regulation exception to the First Amendment. This part demonstrates that claims regarding the unique nature of securities and the necessity for regulations affecting disclosure to preserve U.S. capital markets are unpersuasive. Part V concludes.

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10. *See* JOSEPH J. HEMMER, JR., THE FIRST AMENDMENT: THEORETICAL PERSPECTIVES (2006) (identifying thirty-four First Amendment theories). Schauer also explains,

> [I]f *all* of the historically recognized and judicially mentioned normative theories [of the First Amendment] are available—self-expression, individual autonomy, dissent, democratic deliberation, the search for truth, tolerance, checking governmental abuse, and others—then their collective coverage is so great as to be of little help in explaining the existing state of First Amendment terrain. For if every underlying theory of the First Amendment can be conscripted into service to justify either an inclusion or an exclusion, and if the array of such theories is as large and diverse as it actually is, then all of the work is being done not by the theories, but by as-of-yet unarticulated factors.

Schauer, *supra* note 5, at 1786.

11. In theory, whether the First Amendment is applicable to speech covered by securities regulation is a question separate from the end result of the Amendment's application, and questions "about the involvement of the First Amendment in the first instance are often far more consequential than are the issues surrounding the strength of protection that the First Amendment affords the speech to which it applies." Schauer, *supra* note 5, at 1767. In practice, however, commentators often merge the analyses. *See infra* notes 126–30 and accompanying text. Accordingly, to some extent it is necessary to address the possible consequences of extending the First Amendment to securities regulation, both in terms of whether the regulations would survive scrutiny and whether they are even beneficial in the first place. This is also necessary because , as Schauer has observed, "none of the existing normative accounts appears to explain descriptively much of, let alone most of, the First Amendment's existing inclusions and exclusions." Schauer, *supra* note 5, at 1785.

II. COMMERCIAL SPEECH, SECURITIES REGULATION, AND THE FIRST AMENDMENT

A. *Commercial Speech Doctrine*

Corporations have enjoyed constitutional rights for more than 120 years.[12] The right to First Amendment protection for a corporation's commercial speech, however, was not extended until 1976 in the case of *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*[13] The Supreme Court held that truthful speech that proposed a lawful commercial transaction deserved constitutional protection.[14] The rationale, still used to justify the protection of commercial speech, was based primarily on the listener's interests in hearing the commercial speech.[15]

Four years later in *Central Hudson Gas & Electric Corp. v. Public Service Commission*, the Court set forth a four-factor, intermediate level test for determining the constitutionality of laws affecting commercial speech.[16] The Court applied intermediate level scrutiny rather than strict scrutiny because commercial speech was both hardier and of less importance than speech on

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12. *See* Santa Clara County v. S. Pac. R.R. Co., 118 U.S. 394, 396 (1886) (holding unanimously that corporations are persons deserving protection under the Fourteenth Amendment). For a criticism of this holding, see Reva Dibadj, *The Political Economy of Commercial Speech*, 58 S.C. L. REV. 911, 923–24 (2007).

13. 425 U.S. 748, 773 (1976). Prior to *Virginia State Board of Pharmacy*, protection had been extended implicitly in other contexts: Bigelow v. Virginia, 421 U.S. 809, 829 (1975) (finding unconstitutional a Virginia statute penalizing an advertisement for abortion available in another state); Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations, 413 U.S. 376, 391 (1973) (finding that sex discrimination in an advertisement is not protected speech under the First Amendment because sex discrimination is illegal); N.Y. Times Co. v. Sullivan, 376 U.S. 254, 266 (1964) (holding the First Amendment applicable to an advertisement in a corporation's newspaper). For a more thorough discussion of the development of the commercial speech doctrine, see Antony Page & Katy Yang, *Controlling Corporate Speech: Is Regulation Fair Disclosure Unconstitutional?*, 39 U.C. DAVIS L. REV. 1, 47–60 (2005).

14. *Va. State Bd. of Pharmacy*, 425 U.S. at 773.

15. *Id.* at 759 (stating that recipients have a First Amendment right to receive information); *see, e.g.*, Zauderer v. Office of Disciplinary Counsel, 471 U.S. 626, 651 (1985) (noting "the extension of First Amendment protection to commercial speech is justified principally by the value to consumers of the information such speech provides" (citing *Va. State Bd. of Pharmacy*, 425 U.S. at 763)); Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n, 447 U.S. 557, 563 (1980) (stating that "the First Amendment's concern for commercial speech is based on the informational function of advertising." (citing First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765, 783 (1978))); Lillian R. BeVier, *A Comment on Professor Wolfson's 'The First Amendment and the SEC'*, 20 CONN. L. REV. 325, 328 (1988) (observing that the *Virginia State Board of Pharmacy* opinion "had its source in an empirical observation about how much consumers care about political, as opposed to commercial, speech"); Robert Post, *The Constitutional Status of Commercial Speech*, 48 UCLA L. REV. 1, 14 (2000) ("The Court has been quite explicit that commercial speech should be constitutionally protected so as to safeguard the circulation of information. It has therefore focused its analysis on the need to receive information, rather than on the rights of speakers.").

16. 447 U.S. at 556.

matters of public concern.[17] The *Central Hudson* test requires a court to determine "as a threshold matter whether the commercial speech concerns unlawful activity or is misleading."[18] Commercial speech that is false, misleading, or related to an illegal activity receives no First Amendment protection because listeners have no interest in receiving such speech.[19]

If, however, "the speech concerns lawful activity and is not misleading," then the Court inquires

> "whether the asserted governmental interest is substantial." If it is, then [the Court] "determine[s] whether the regulation directly advances the governmental interest asserted," and, finally, "whether it is not more extensive than is necessary to serve that interest." Each of these latter three inquiries must be answered in the affirmative for the regulation to be found constitutional.[20]

Although this test has been frequently criticized, not least by the Justices themselves, it remains good law.[21]

In addition to protecting against government restrictions on speech, the First Amendment also protects against compelled speech,[22] even when the compelled speaker is a corporation.[23] The protection extended for compelled pure commercial speech is generally low, in large part because compelled speech is often necessary to reduce the risk of consumer deception through such

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17. *Id.* at 564 n.6; *see also Va. State Bd. of Pharmacy*, 425 U.S. at 771–72 n.24 (providing that political speech—commentary about governmental activities—on the other hand is easily "chilled" and so must be protected); *First Nat'l Bank of Boston*, 435 U.S. at 776 (noting that speech on "'matters of public concern'" is "at the heart of the First Amendment's protection" (quoting Thornhill v. Ala., 310 U.S. 88, 101 (1940))).

18. Thompson v. W. States Med. Ctr., 535 U.S. 357, 367 (2002) (quoting *Central Hudson*, 447 U.S. at 566).

19. *Central Hudson*, 447 U.S. at 563–64 (1980) (observing that because commercial speech is valued for conveying information, "there can be no constitutional objection to the suppression of commercial messages that do not accurately inform the public about lawful activity. The government may ban forms of communication more likely to deceive the public than to inform it, or commercial speech related to illegal activity." (citations omitted)). The Court has not yet clarified what it means by misleading speech. *See* David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395, 1420–27 (2006).

20. *Thompson*, 535 U.S. at 367 (quoting *Central Hudson*, 447 U.S. at 566) (citations omitted).

21. *Id.* at 367–68 (applying *Central Hudson* while acknowledging that several Justices had "expressed doubts" about the analysis).

22. *See, e.g.*, Riley v. Nat'l Fed'n of the Blind of N.C., Inc., 487 U.S. 781, 795, 803 (1988) (upholding a challenge to a state law requiring that fundraisers disclose the percentage of contributions to be received by the charity); Wooley v. Maynard, 430 U.S. 705, 713 (1977) (declaring that "[t]he right to speak and the right to refrain from speaking are complementary components of the broader concept of 'individual freedom of mind.'" (quoting W.V. State Bd. of Educ. v. Barnette, 319 U.S. 624, 637 (1943))).

23. *See, e.g.*, Pac. Gas & Elec. Co. v. Pub. Util. Comm'n of Cal., 475 U.S. 1, 20–21 (1986); United States v. United Foods, Inc., 533 U.S. 405, 408–09 (2001).

compelled speech.[24] However, this has not stopped the Court from striking down such regulations,[25] or equating compelled commercial speech with compelled, traditionally protected noncommercial speech.[26]

Although it is clear that the First Amendment applies to commercial speech, it is much less clear what exactly constitutes commercial speech. *Virginia State Board of Pharmacy* provided two definitions, characterizing commercial speech either as speech communicating the sale of product *X* at price *Y* or speech describing a lawful commercial transaction.[27] *Central Hudson* provided a broader definition: "[E]xpression related solely to the economic interests of the speaker and its audience."[28] Later cases, however, sometimes went back to earlier definitions.[29] Not surprisingly, the Supreme Court has admitted that there is no categorical definition distinguishing commercial and noncommercial speech[30] and that "ambiguities may exist at the margins of the category of commercial speech."[31] Commentators (and even other judges) have been far less charitable.[32]

It is worth noting, however, that the concern is normally not distinguishing between commercial speech and unprotected speech but instead distinguishing between commercial speech and more protected speech. Justice Stevens, for example, wrote that "it is important that the commercial speech concept not be defined too broadly lest speech deserving of greater constitutional protection be inadvertently suppressed."[33] Similarly, some of the critics of those who advocate

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24. *See, e.g.*, Zauderer v. Office of Disciplinary Counsel, 471 U.S. 626, 651 (1985) (holding that "'[warnings] or [disclaimers] might be appropriately required . . . in order to dissipate the possibility of consumer confusion or deception'" (quoting *In re* R.M.J., 455 U.S. 191, 201 (1982))); *United Foods,* 533 U.S. at 408, 416 (2001) (striking down a requirement that mushroom growers contribute to generic advertising, in part because there was no possibility of consumer deception).

25. *See, e.g., United Foods*, 533 U.S. at 416.

26. *Id.* at 410 (citing numerous compelled speech cases that did not involve commercial speech).

27. Va. State Bd. of Pharmacy v. Virginia Citizens Consumer Council, Inc., 425 U.S. 748, 761, 770 (1976) (quoting Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations, 413 U.S. 376, 385 (1973)).

28. Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n, 447 U.S. 557, 561 (1980) (citations omitted).

29. *See, e.g.*, Bd. of Trs. of State Univ. of N.Y. v. Fox, 492 U.S. 469, 473–74 (1989) (describing the proposal of a "commercial transaction" as the test for identifying commercial speech (quoting *Va. State Bd. of Pharmacy*, 425 U.S. at 762)).

30. *See* Rubin v. Coors Brewing Co., 514 U.S. 476, 493 (1995) (Stevens, J., concurring) ("[T]he borders of the commercial speech category are not nearly as clear as the Court has assumed . . . ."); Edenfield v. Fane, 507 U.S. 761, 765 (1993); City of Cincinnati v. Discovery Network, Inc., 507 U.S. 410, 419 (1993).

31. *Edenfield*, 507 U.S. at 765.

32. Kasky v. Nike, Inc., 45 P.3d 243, 268 (Cal. 2002) (Brown, J., dissenting) (observing that "the United States Supreme Court has expressly refused to define the elements of commercial speech"). Not everyone has objected to the indeterminacy. *See generally* Nat Stern, *In Defense of the Imprecise Definition of Commercial Speech*, 58 MD. L. REV. 55, 57 (1999) (arguing that the Court has developed a flexible jurisprudence that allows the First Amendment to develop and evolve).

33. *Central Hudson*, 447 U.S. at 579 (Stevens, J., concurring); *see also* Bolger v. Youngs Drug Prods. Corp., 463 U.S. 60, 66 (1983) (stating that courts must be "careful[] to ensure that speech deserving of greater constitutional protection is not inadvertently suppressed").

expanded First Amendment protection for securities regulation have focused their efforts on distinguishing speech affected by securities regulation not from commercial speech, but rather from traditionally more protected speech.[34]

The treatment of mixed speech, involving both commercial and noncommercial messages, is also unclear. For example, Toyota advertising its hybrid car is a commercial message. "Fight global warming" is a noncommercial, political message. Toyota showing how you can and should fight global warming by purchasing a hybrid car would likely be mixed speech.[35] The degree of permissible regulation depends in part on whether the messages are inseparable, or as the Court has stated, "inextricably intertwined."[36] The Court has noted that state regulations do not get the benefit of intermediate level First Amendment scrutiny for commercial speech that is inextricably intertwined with otherwise fully-protected speech.[37] On the other hand, simply including references to public issues is inadequate to immunize advertising from government regulation.[38] The issue with speech affected by securities regulation, however, is in the first instance between protected and unprotected speech rather than the nuances of the applicable level of scrutiny.[39]

Arguably, the distinction between commercial speech and more protected speech has become less important over the last decade as the Supreme Court has become increasingly protective of commercial speech.[40] In a series of cases involving commercial speech relating to liquor,[41] gambling,[42] tobacco,[43] and prescription drugs,[44] the government has lost. The actual level of review appears

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34. *See, e.g.*, BeVier, *supra* note 15, at 325–31 (arguing that commercial speech and political or artistic speech can be distinguished based on the content and context of the speech); Michael P. Dooley, *The First Amendment and the SEC: A Comment*, 20 CONN. L. REV. 335, 348 (1988).

35. For a long list of marketing and advertising communications that may be mixed speech, see La Fetra, *supra* note 9, at 1230–36.

36. Bd. of Trs. of State Univ. of N.Y. v. Fox, 492 U.S. 469, 474 (1989) (quoting Riley v. Nat'l Fed'n of the Blind of N.C., Inc., 487 U.S. 781, 796 (1988)).

37. *Riley*, 487 U.S. at 796.

38. *Fox*, 492 U.S. at 474 ("No law of man or of nature makes it impossible to sell housewares without teaching home economics, or to teach home economics without selling housewares."); *Bolger*, 463 U.S. at 67–68.

39. For an interesting discussion of the increasing importance of mixed speech in the context of securities regulation, see Siebecker, *supra* note 3, at 621–28. *See also* Tom Bennigson, *Nike Revisited: Can Commercial Corporations Engage in Non-Commercial Speech?*, 39 CONN. L. REV. 379, 383 (2006) (arguing that "all speech by publicly traded for-profit business corporations is commercial speech" but leaving open whether and what level of First Amendment protection is appropriate).

40. *See, e.g.*, *Free Speech Protections for Corporations: Competing in the Markets of Commerce and Ideas*, 117 HARV. L. REV. 2272, 2272 (2004) (noting that "commercial speech has enjoyed greater protection in recent years"); Stern, *supra* note 32, at 68–72 (referring to the resurgence in the '90s of commercial speech protection); Eugene Volokh, *Freedom of Speech and Intellectual Property: Some Thoughts after* Eldred, 44 Liquormart, *and* Bartnicki, 40 HOUS. L. REV. 697, 732 (2003) (observing that the Court "has been providing more and more protection [to commercial speech] since the early 1990s").

41. 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 489 (1996).

42. Greater New Orleans Broad. Ass'n, Inc. v. United States, 527 U.S. 173, 176 (1999).

43. Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 553 (2001).

44. Thompson v. W. State Med Ctr., 535 U.S. 357, 360 (2002).

to be closer to a strict rather than an intermediate level of scrutiny.[45] Conversely, if commercial speech has become more protected, the distinction between commercial speech and unprotected corporate speech (such as the speech affected by securities regulation) becomes much more important. The next section looks at how the courts to date have treated securities regulation under the First Amendment.

B. Courts' Treatment of Securities Regulation Under the First Amendment

Why the First Amendment might not or should not apply to securities regulations would be primarily of interest only to academics if the Supreme Court had already conclusively decided the issue. The Supreme Court, however, has provided little guidance regarding the First Amendment's application to securities regulation.

Nevertheless, some commentators have argued that its application has been foreclosed.[46] For example, twenty-two prominent securities law professors signed an amicus brief supporting the SEC in its case against Siebel Systems.[47] The brief argued that there was an exception from the First Amendment for securities regulation based on dicta from two early cases suggesting that the amendment was inapplicable to at least some securities regulations.[48]

The more important dictum is from the 1978 case, *Ohralik v. Ohio State Bar Ass'n*[49]:

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45. *See, e.g.*, Note, *Making Sense of Hybrid Speech: A New Model for Commercial Speech and Expressive Conduct*, 118 HARV. L. REV. 2836, 2853–56 (2005) (arguing that in recent years protection for commercial speech has moved towards strict scrutiny due to the Justices' current preference for bright-line rules and changes in advertising that make it more expressive like protected art).

46. *See, e.g.*, Allen Boyer, *Free Speech, Free Markets, and Foolish Consistency*, 92 COLUM. L. REV. 474, 495 (1992) (reviewing WOLFSON, *supra* note 8) (claiming that "the [Supreme] Court has . . . rejected *any implication* that the First Amendment should be applied in the securities field") (emphasis added).

47. *See* Brief of Law Professors as Amicus Curiae in Opposition to Motion to Dismiss at 16–22, SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (2004). The list of signatories reads like a listing from a Who's Who of securities professors: John C. Coffee, Jr., Alan R. Bromberg, James D. Cox, Melvin A. Eisenberg, Jill E. Fisch, Theresa A. Gabaldon, Thomas Lee Hazen, Howell Jackson, Donald C. Langevoort, Ronald M. Levin, Henry Monaghan, Donna M. Nagy, Neil M. Richards, Margaret V. Sachs, Hillary A. Sale, Joel Seligman, Larry D. Soderquist, Marc I. Steinberg, Lynn Stout, Steven Thel, Robert B. Thompson, and William K.S. Wang. *Id.* Interestingly, although the brief referred to the securities exemption as "obvious," the SEC chose to defend Regulation Fair Disclosure only in small part on that basis, and primarily on the basis that it was actually a time, place, and manner restriction, or was akin to commercial speech under the *Central Hudson* definition, or could survive strict scrutiny. SEC Opposition to Motion to Dismiss at 17–22, SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005) (No. 04 CV 5130), 2004 WL 3142263.

48. *See* Brief of Law Professors, *supra* note 47, at 17. These dicta are discussed *infra* at notes 49–61 and accompanying text.

49. 436 U.S. 447 (1978). The brief also relied on the argument that many securities laws (and commercial regulations in other areas of law, such as antitrust, sexual harassment and trademark) would then also be constitutionally suspect. *See* Brief for Law Professors, *supra* note 50, at 17. This argument is addressed *infra* at notes 111–25 and accompanying text.

> [I]t has never been deemed an abridgment of freedom of speech or press to make a course of conduct illegal merely because the conduct was in part initiated, evidenced, or carried out by means of language, either spoken, written, or printed. Numerous examples could be cited of communications that are regulated without offending the First Amendment, such as the exchange of information about securities, corporate proxy statements, the exchange of price and production information among competitors, and employers' threats of retaliation for the labor activities of employees. Each of these examples illustrates that the State does not lose its power to regulate commercial activity deemed harmful to the public whenever speech is a component of that activity.[50]

The foregoing appears in a case that was decided only two years after *Virginia State Board of Pharmacy* and two years before *Central Hudson*. In other words, *Ohralik* was decided well before the doctrine of commercial speech was fully developed or began being applied more strictly. In addition, the language hardly supports a blanket exemption for all securities regulation. Rather, the speech covered by the language, "exchange of information about securities" (and corporate proxy statements), is far from identical to all of the speech covered by securities regulation. "Exchange of information about securities" cannot, for example, cover a corporation's advertisements for products, since such advertisements are squarely within the commercial speech doctrine. Yet federal securities regulation reaches these advertisements. Likewise Regulation FD applies to *any* material nonpublic information,[51] regardless of whether it can reasonably be said to be about a security.

The Court's language on its face would also include securities newsletters, which have had some success litigating under the First Amendment. Of course, the language on its face would also include investment columns in such periodicals as the *Wall Street Journal*, *Barron's*, and the *New York Times* that have traditionally received the full measure of First Amendment protection. Although the Supreme Court has not resolved the issue with respect to securities newsletters, the question was raised in *Lowe v. SEC*.[52] This case was ultimately decided based on a narrow statutory interpretation of the Investment Advisers

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50. *Ohralik*, 436 U.S. at 456 (citations omitted). This language was later quoted in part in *Dun & Bradstreet, Inc. v. Greenmoss Builders*, 472 U.S. 749, 758, n.5 (1985); however, the opinion only received the support of three Justices. It was also recently quoted in *Tennessee Secondary School Athletic Ass'n v. Brentwood Academy*, 127 S. Ct. 2489 (2007), *available at* 2007 WL 1773196, in a portion of the principal opinion joined by only four Justices. These four Justices noted that *Ohralik*'s holding was "narrow" and "limited to conduct that is inherently conducive to overreaching and other forms of misconduct." *Id.* at 5 (citations omitted). Four other Justices agreed that *Ohralik*'s holding was narrow but further limited it to "certain unique features of in-person solicitation by lawyers that were present in the circumstances of that case." *Id.* at 9 (citations omitted).

51. 17 C.F.R. § 243.100(a) (2006).

52. 472 U.S. 181, 210 (1985).

Act of 1940, but the majority opinion also stated that "it is difficult to see why the expression of an opinion about a marketable security should not" be protected by the First Amendment.[53] In a concurrence, Justice White, supported by two other Justices, went even further. He would have held that the Act violated the First Amendment because it operated as a prior restraint that was an extreme means of preventing a mere possibility of fraud.[54]

Dictum in the 1973 case, *Paris Adult Theatre I v. Slaton*,[55] may also shed light on the meaning of the *Ohralik* dictum. The *Paris Adult Theatre I* language is similar but distinctively different: "[B]oth Congress and state legislatures have, for example, . . . strictly regulated *public expression by issuers of and dealers in securities*, profit sharing 'coupons,' and 'trading stamps,' commanding what they must and must not publish and announce."[56] The speech covered in the phrase "public expression by issuers of and dealers in securities" is much broader than the phrase "exchange of information about securities" with respect to issuers and dealers and is inapplicable to the regulation of third parties' speech other than dealers. The Court in *Ohralik* may have used narrower and more precise language to cut back on the reach of any exemption.[57]

In addition, supporters of a securities exemption tend to leave out the sentences immediately preceding the above quote. The Court wrote that "legislators and judges have acted on various unprovable assumptions," and such assumptions are the basis underlying Congress's and state legislatures' lawful "regulation of commercial and business affairs."[58] Now, however, with modern financial theory, ready access to vast computational power, and an ever increasing amount of data, there is some evidence regarding the validity of these "unprovable assumptions."[59] In any case, the Court has not hesitated in some instances to adopt modern empirical findings that shed light on the efficacy of securities regulation, such as in *Basic Inc. v. Levinson*,[60] when it accepted a plaintiff's fraud on the market theory based on the efficient capital market

53. *Id.* at 210 n.58.

54. *Id.* at 234 (White, J., concurring). The concurrence expressly left open the question of whether the investment newsletter contained commercial speech or fully protected speech. *Id.*

55. 413 U.S. 49 (1973).

56. *Id.* at 61–62 (citations omitted) (emphasis added).

57. The language in *Ohralik* may also reflect the holding of *First National Bank of Boston v. Belotti*, 435 U.S. 765 (1978), which was decided just one month earlier. In that case the Supreme Court applied strict scrutiny to regulation of corporate speech on matters "intimately related to the process of governing." *Id.* at 786.

58. *Paris Adult Theatre I*, 413 U.S. at 61.

59. *See infra* Part IV.B. Admittedly there may not yet be enough evidence, especially since the results are mixed, but in all likelihood the assumptions underlying securities regulation should no longer be considered unprovable.

60. 485 U.S. 224 (1988) (accepting empirical studies suggesting that "the market price of shares traded on well-developed markets reflects all publicly available information"). Justice White, however, dissented from the majority's decision, arguing that federal courts had "no ability to test the validity of empirical market studies" and should defer to Congress in "determining how modern economic theory and global financial markets require" changes in established legal notions. *Id.* at 253–54 (White, J., dissenting).

hypothesis.[61]

A related argument in favor of a securities regulation exemption has been suggested by, among others, the First Circuit. In 1978, the appellate court stated, "Though first amendment protection has lately been afforded some types of commercial speech, the first amendment has not yet been held to limit regulation in areas of extensive economic supervision, such as the securities, antitrust, and transportation fields . . . ."[62] The D.C. Circuit later developed this argument:

> We believe instead that the government may have the power to regulate Stock Market Magazine, not because the articles are "commercial speech," but rather because of the federal government's broad powers to regulate the securities industry. Where the federal government extensively regulates a field of economic activity, communication of the regulated parties often bears directly on the particular economic objectives sought by the government, and regulation of such communications has been upheld. If speech employed directly or indirectly to sell securities were totally protected, any regulation of the securities market would be infeasible—and that result has long since been rejected.[63]

Leaving aside the closing straw man argument (few commentators believe that speech employed directly or indirectly to sell securities should be *totally* protected), there appears to be more support for this kind of exemption.[64] The Supreme Court has sometimes been more deferential of regulations affecting speech in extensively regulated industries, such as the legal profession,[65] fruit

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61. *Id.* at 246.

62. Bangor & Aroostook R.R. Co. v. Interstate Commerce Comm'n, 574 F.2d 1096, 1107 (1st Cir. 1978) (citations omitted).

63. SEC v. Wall St. Publ'g Inst., Inc., 851 F.2d 365, 372–73 (D.C. Cir. 1988) (citations omitted). The opinion goes on to acknowledge, however, that "we think it would be an overstatement to assert that the First Amendment does not *limit* regulation in the securities field," but not so much that it was even necessary to determine "whether the government's specific regulatory objective . . . is constitutionally permissible." *Id.* at 373 (emphasis in original).

64. Schauer suggests that as a descriptive matter the presence of a well-entrenched regulatory scheme has significance in determining the coverage of the First Amendment. *See* Schauer, *supra* note 5, at 1805–06.

65. *See, e.g.*, Ohralik v. Ohio State Bar Ass'n, 436 U.S. 447, 468 (1978) (upholding state bar disciplinary rule).

growing,[66] and gambling.[67]

On the other hand, the government also extensively regulates both prescription drugs and tobacco use, and the Supreme Court has recently struck down regulations affecting those two industries.[68] Before that, the Court struck down regulations affecting alcohol and gambling.[69] It seems safe to say that extensive economic regulation is now less likely to justify a more deferential application of the First Amendment and even less likely to justify a complete exemption.

In addition, the D.C. Circuit's phrase, "speech employed directly or indirectly to sell securities," is an imprecise term that is likely narrower than all speech covered by securities regulation, "public expression by issuers of and dealers in securities," or "exchange of information about securities and corporate proxy statements."[70] Because ordinary advertising of goods and services (that are not securities) to consumers (e.g., commercial speech) receives First Amendment protection, such advertising should be considered speech indirectly employed to sell securities. Presumably, image-building corporate advertising would also receive such protection. Similarly, it is unlikely that the kind of speech that appears in proxy statements is plausibly considered speech intended to sell securities.

Finally, there exists competing dictum in a 1988 case. In *Riley v. National Federation of the Blind of North Carolina, Inc.*,[71] the Supreme Court majority implied that securities regulation did affect commercial speech[72]: "Of course, the dissent's analogy to the securities field entirely misses the point. Purely commercial speech is more susceptible to compelled disclosure requirements."[73]

Since these cases, several courts have applied the First Amendment to cases

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66. *See, e.g.*, Glickman v. Wileman Bros. & Elliott, Inc., 521 U.S. 457, 469–72 (1997) (upholding compelled contributions by fruit growers for generic advertising). Interestingly the Court struck down a similar provision four years later involving mushrooms, an industry that was not heavily regulated. United States v. United Foods, Inc., 533 U.S. 405, 416 (2001). More recently, the Court upheld a similar provision involving the beef industry on the basis that the speech was government speech rather than private party commercial speech. *See* Johanns v. Livestock Mktg. Ass'n., 544 U.S. 550, 562 (2005).

67. *See* Posadas de P. R. Assocs. v. Tourism Co. of Puerto Rico, 478 U.S. 328, 344 (1986) (upholding prohibition of casino advertising). *But see* 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 509–10 (Stevens, J., plurality) (concluding "that *Posadas* erroneously performed the First Amendment analysis").

68. *See, e.g.*, Thompson v. W. States Med. Ctr., 535 U.S. 357, 360 (2002) (prescription drugs); Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 553 (2001) (tobacco). The case that jump-started the commercial speech doctrine was also about prescription drugs. *See* Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 749–50 (1976).

69. *44 Liquormart, Inc.*, 517 U.S. at 489 (alcohol); Greater New Orleans Broad. Ass'n v. United States, 527 U.S. 173, 176 (1999) (gambling).

70. *See supra* note 63 and accompanying text. The D.C. Circuit was addressing a situation where issuers may have provided consideration to a magazine for publishing favorable articles. *See* SEC v. Wall St. Publ'g Inst., Inc., 851 F.2d 365, 366 (D.C. Cir. 1988). The dispute was simply whether the magazine had to disclose the consideration. *Id.*

71. 487 U.S. 781 (1988).

72. *Id.* at 796 n.9 (citations omitted).

73. *Id.*

involving regulations of publishers of investment advice[74] or journalists.[75] The D.C. Circuit applied the First Amendment in a case involving an SEC regulation restricting contributions and solicitations for contributions to political campaigns.[76] Another court has avoided a constitutional challenge to a securities regulation through statutory interpretation.[77]

Even if the Supreme Court's nearly thirty-year-old dictum in *Ohralik* once foreclosed application of the First Amendment to securities regulation, that does not necessarily foreclose its application now. The SEC itself accepted in 1992 that there were "serious" First Amendment questions regarding some securities regulations.[78] Furthermore, Schauer observes that as a descriptive matter there is significant expansionary pressure on the coverage of the First Amendment.[79] Referring to this expansion as caused by the amendment's "magnetism," he notes how this pressure "can be expected to bring issues into the First Amendment that previously had been outside its domain," especially as "no equivalent force pushes out those issues that had previously been inside."[80] Accordingly, whatever the state of the law may have been, the question of the First Amendment's application to securities regulation is an open one now.

III. SECURITIES REGULATION'S IMPACT ON SPEECH

As former SEC Commissioner Roberta Karmel has noted, "[s]ecurities

74. *See, e.g.*, Taucher v. Brown-Hruska, 396 F.3d 1168, 1169–70 (D.C. Cir. 2005) (holding that the Commodity Futures Trading Commission's unsuccessful defense of a portion of the Commodities Exchange Act against an as applied First Amendment challenge was reasonable and thus the award of attorneys' fees under the Access to Justice Act was vacated); Commodity Trend Serv., Inc. v. Commodity Futures Trading Comm'n, 149 F.3d 679, 685–86 (7th Cir. 1998) (holding that publishing advice about investments in commodities was fully protected speech under the First Amendment); Lubin v. Agora, 882 A.2d 833, 846 (Md. 2005) (rejecting the Maryland Securities Commissioner's contention that subscribers to an investors' newsletter and email had a lower level of First Amendment protection because it "may have been 'commercial speech,' possibly even false commercial speech"). Other courts have effectively applied rational review, either on a theory that the regulation is necessary to prevent deception, as in *United States v. Wenger*, 292 F. Supp. 2d 1296, 1298 (D. Utah 2003), or based on "the federal government's broad powers to regulate the securities industry," as in *Wall St. Publ'g Inst.*, 851 F.2d at 372 (citations omitted).

75. *In re* Scott Paper Co. Sec. Litig., 145 F.R.D. 366, 370 (E.D. Pa. 1992).

76. Blount v. SEC, 61 F.3d 938, 944–47 (D.C. Cir. 1995) (holding that SEC's anti-"pay-to-play" Rule G-37 survived strict First Amendment scrutiny).

77. SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 709 n.16 ("Since the complaint itself fails to allege a cognizable cause of action for violation of Regulation FD, this Court declines to opine on the constitutional challenges raised.").

78. *See* Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, Investment Company Act Release No. 19,031, 57 Fed. Reg. 48,276, 48,279 (Oct. 22, 1992); *see also* Blount v. SEC, 61 F.3d 938, 946 (D.C. Cir. 1995) (noting that the SEC "explained that the 'loopholes' that remain [in Rule G-37] are due to its 'sensitivity' to First Amendment concerns").

79. *See, e.g.*, Schauer, *supra* note 5, at 1790–98 (explaining how issues become reclassified as First Amendment issues); see also Blasi, *supra* note 9, at 479 ("As recently as 1957 our first amendment tradition did not protect the freedom to form political associations or the freedom to speak anonymously.").

80. Schauer, *supra* note 5, at 1796.

regulation is essentially the regulation of speech."[81] Frederick Schauer described the SEC as the "Content Regulation Commission."[82] James Goodale pointed out "there is no greater statutory regulation of speech than the '33 and '34 Securities Acts and the '40 Investment Adviser and Investment Company Acts."[83] Although it is beyond the scope of this Article to provide a complete description of all the securities regulations affecting speech, a broad overview and examples can be provided.

Typically, federal securities regulation is about mandating issuer disclosure. Louis Loss and Joel Seligman in their influential treatise stated, "[T]here is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure. Substantive regulation has its limits. But '[t]he truth shall make you free.'"[84] Obvious examples of this are the registration statement requirements contained in the Securities Act of 1933 ('33 Act) and the mandatory reporting requirements contained in the Securities Exchange Act of 1934 ('34 Act). Issuers and reporting companies are required to disclose a wide range of business and financial information. The Sarbanes-Oxley Act of 2002 further extended reporting requirements in a variety of areas.[85]

Disclosure is generally required because it is material, and it "is material if there is a substantial likelihood that a reasonable shareholder would consider it important" to an investment decision.[86] Materiality is not determined solely by the magnitude of the information. It may also be triggered by investors' reactions to the information; thus, a director in the SEC's Division of Corporate Finance has suggested that even a small amount of business with countries or governments facing U.S. economic sanctions will be considered material.[87]

In the case of proxy statements, a company may be required to disclose a shareholder's speech.[88] Companies may normally exclude proposals that relate

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81. Roberta S. Karmel, Introduction, *The First Amendment and Government Regulation of Economic Markets*, 55 BROOK. L. REV. 1, 1 (1989). Citations to 55 *Brooklyn Law Review* refer to page numbers as indicated on original printed pages.

82. Schauer, *supra* note 5, at 1778.

83. Goodale, *supra* note 3, at 1.

84. 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 29 (3d ed. 1998); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (stating that the federal securities laws are premised on "a philosophy of full disclosure").

85. *See, e.g.*, Sarbanes-Oxley Act of 2002 § 403(a), 15 U.S.C. § 78(p)a (Supp. IV 2004) (amending Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (2000)) (describing the disclosure obligations of directors, officers, and principal shareholders); § 404, 15 U.S.C. § 7262 (Supp. IV 2004) (requiring management to disclose its assessment of internal controls).

86. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

87. Memorandum from David B.H. Martin, Dir., Div. of Corp. Fin., SEC, to Laura Unger, Acting Chair, SEC (May 8, 2001), attachment to Letter from Laura S. Unger, Acting Chair, SEC, to Congressman Frank P. Wolf (May 8, 2001), 2001 SEC No-Act LEXIS 579, at *15. *See generally* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1273–89 (1999) (arguing in favor of mandated corporate "social disclosure").

88. 17 C.F.R. §240.14a-8 (2006).

to "ordinary business operations"[89] but generally must include those that focus on "sufficiently significant social policy issues."[90] Institutional Shareholder Services, a company that provides corporate governance advice, produces background reports on proxy voting on such social policy issues as animal welfare, board diversity, environmental change, human rights, and employment issues.[91] Occasionally, shareholders' social policy proposals require a company to include speech in its proxy statements that appears directly adverse to the company's interests. For example, Sturm, Ruger & Company, Inc., a large gun manufacturer, was unable to exclude a shareholder proposal that requested the board prepare a report "on company policies and procedures aimed at stemming the incidence of gun violence in the United States."[92]

Sometimes, however, and more controversially both from a theoretical standpoint and from its potential ultimately to violate the First Amendment, securities regulations not only mandate disclosure but also restrict disclosure. For example, section 4(2) of the '33 Act provides an exemption from the registration requirements for securities "not involving any public offering."[93] An offering can still be large, both in financial terms and in the number of participants, since buyers can include an unlimited number of accredited investors.[94] The issuer, however, generally cannot advertise, even if no ineligible investors actually invest in the issuer, because Rule 502(c) requires that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising."[95]

In the public offering context, offers may only be made by a prospectus, but an offer is defined to include any written communication that might condition the market.[96] This written communication, according to the SEC, includes almost anything issued by the company, including written communication with no direct connection to the securities offering, such as an increase in

89. § 240.14a-8(i)(7) (listing several exceptions, including proposals concerning "ordinary business operations").

90. Staff Legal Bulletin No. 14A, Div. of Corp. Fin., SEC, Shareholder Proposals (July 12, 2002), *available at* http://sec.gov/interps/legal/cfslb14a.htm (quoting Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,018, 63 Fed. Reg. 29,106, 29,108 (May 28, 1998)). There were at least 179 social policy shareholder proposals voted on in the eight months ending August 2006. *See* Proxy Governance News Release, Sept. 13, 2006, *available at* http://www.proxygovernance.com/content/pgi/content/press/press_release_20060913.shtml/.

91. Institutional Shareholder Services, Social Issues Services, http://www.issproxy.com/research/usccustom.html (last visited June 15, 2007).

92. Sturm, Ruger & Co., SEC No-Action Letter, 2001 SEC No-Act. LEXIS 342, *2–3 (March 5, 2001).

93. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (2000).

94. Revision of Certain Exemptions from Registration, Securities Act Release No. 5389, 47 Fed. Reg. 11,251, 11,252 (March 16, 1982). For a thoughtful discussion of exempt offerings and why the advertising restrictions should be scrapped on policy grounds, see William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 4–5 (2004).

95. 17 C.F.R. § 230.502(c) (2006).

96. 17 C.F.R. § 230.133(a) (2006).

advertisements for an issuer's products.[97] This explains why the time period before a registration statement becomes effective is known as the "quiet period."[98] As the *Wall Street Journal* has observed, "in practice the rules can deprive investors of information, prevent stock research from being published and limit a company's ability to respond to misinformation in the media."[99]

Securities regulations restrict more than just advertising. Regulation FD, for example, prevents a company from disclosing material nonpublic information to certain parties unless the company also discloses such information publicly.[100] The SEC in some situations prevents oil and gas companies from disclosing either their probable reserves or any reserves that were proven based on technology developed since 1978.[101] In addition, companies are required to make their estimates of reserves based on the year-end price rather than an average price or their best prediction of what the price will be.[102] The result is that "[t]he SEC doesn't allow companies to use all data at their disposal."[103] The author of this Article had first hand experience with this SEC rule when he was involved with an oil company's initial public offering. All references to probable reserves that were on the company's web site had to be deleted before the SEC would allow the offering to proceed. Similarly, the *Wall Street Journal* reported about an unnamed company that had 658 million barrels of oil using modern technology but was only permitted to disclose 261 million barrels under the SEC guidelines.[104] As the CEO of one firm of petroleum consultants noted, "it is easy to see why investors can be confused or unintentionally misled" by the SEC's disclosure requirements.[105]

Finally, securities regulations do more than just affect the speech of issuers. For example, shareholders or employees of an issuer who "make a solicitation or

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97. 17 C.F.R. § 230.134(a) (2006) (exempting tombstone ads from the definition of prospectus).

98. Jesse Eisinger, *'Quiet Period' Ahead of IPOs Needs to End*, WALL ST. J., Aug. 18, 2004, at C1 (recommending the SEC should abandon the required quiet period).

99. *Id.*

100. Regulation FD, 17 C.F.R. § 243.100 (2006). See Page & Yang, *supra* note 13, at 8–18 for a detailed discussion of Regulation FD's effects.

101. *See* Regulation S-K, 17 C.F.R. § 229.801 (2006); Daniel Yergin, Op-ed., *How Much Oil is Really Down There?*, WALL ST. J., April 27, 2006, at A18. Proved or proven reserves are those for which there is a 90% likelihood of recovery. *See* SOCIETY OF PETROLEUM ENGINEERS, GUIDELINES FOR THE EVALUATION OF PETROLEUM RESERVES AND RESOURCES 112, 134 (2001), *available at* http://www.spe.org/spe-site/spe/spe/industry/reserves/GuidelinesEvaluationReservesResources_2001.pdf. Probable reserves are those for which the likelihood is 50%. *Id.* at 135. This quantity is also dependent on the price of oil, for the likelihood of recovery increases as the price increases. *Id.* at 113; *see also* OIL AND GAS RESERVES COMMITTEE, SOCIETY OF PETROLEUM ENGINEERS ET AL., PETROLEUM RESOURCES MANAGEMENT SYSTEM 42, 43 (2007), *available at* http://www.spe.org/spe-site/spe/spe/industry/reserves/Petroleum_Resources_Management_System_2007.pdf.

102. Steve LeVine, *Oil Firms Want SEC to Loosen Reserve Rules*, WALL ST. J., Feb. 7, 2006, at C1.

103. *Id.* (quoting David Hobbs, Cambridge Energy Research Associates managing director for oil and gas research).

104. Yergin, *supra* note 101.

105. Ron Harrell, *Whose Reserves Estimates Can I Trust?*, WORLD ENERGY 104 (2004), *available at* http://www.worldenergysource.com/articles/text/harrell_WE_v7n1.cfm.

recommendation" must file a Tender Offer Solicitation/Recommendation Statement on Schedule 14D-9.[106] Such a filing may cost more than $50,000.[107] A high profile example of this situation occurred when employees of Willamette Industries, facing a hostile tender offer from Weyerhaeuser, set up a website (JustSayNoWey.com) opposing the transaction.[108] The employees took down the site after the SEC asked them to "either retain legal counsel and file required SEC forms, or cease all Just Say No Wey activities."[109] As the group's spokesperson observed, "[t]he SEC regulation says we can't make recommendations as to the validity or merits of the takeover."[110] Rule 14d-9 can thus effectively serve as a prohibition on speech.

IV. ADDRESSING ARGUMENTS THAT THE FIRST AMENDMENT SHOULD NOT APPLY TO SECURITIES REGULATION

After the Supreme Court's decision in *Virginia State Board of Pharmacy*,[111] commentators began writing about its implications for the application of the First Amendment to other areas of law.[112] With respect to securities regulation, in 1983 in an often-cited piece, James Goodale opined, "[o]ne trend is clear: the SEC's regulation of securities will no longer enjoy an automatic immunity from the dictates of the First Amendment."[113] Other commentators in the mid- and late 1980s and early 1990s argued in favor of First Amendment scrutiny, if not to the entire field of securities regulation, at least in some areas.[114] More recently, in

106. 17 C.F.R. §240.14d-9(b)(1), (e)(1) (2006).

107. Robin Sidel, *Web Site Draws SEC Concern in Bid Battle*, WALL ST. J., May 7, 2001, at C1.

108. *See SEC Takes Willamette Workers Out of Proxy Fight*, PUGET SOUND BUS. J., May 4, 2001, *available at* http://seattle.bizjournals.com/seattle/stories/2001/05/07/tidbits.html; *see also* Sidel, *supra* note 107 (describing employee reaction to takeover bid). Although the employees' site was taken down following the SEC's intervention, an archived version can be found at http://web.archive.org/web/20010420084523/http://www.justsaynowey.com/.

109. *SEC Takes Willamette Workers Out of Proxy Fight*, *supra* note 108.

110. *Id.*

111. Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748 (1976).

112. *See, e.g.*, Schauer, *supra* note 5, at 1781–84 (describing commentary in favor of expanding the coverage of the First Amendment in the law of antitrust, labor, sexual harassment law, copyright, and trademark).

113. Goodale, *supra* note 3, at 4.

114. *See* WOLFSON, *supra* note 8, at 5 (opining that "SEC-regulated" speech deserves First Amendment protection); Henry N. Butler & Larry E. Ribstein, *Corporate Governance Speech and the First Amendment*, 43 U. KAN. L. REV. 163, 163–65 (1994) (comparing corporate speech with political speech); Aleta G. Estreicher, *Securities Regulation and the First Amendment*, 24 GA. L. REV. 223, 226 (1990) (arguing for the protection of securities advertising); Donald E. Lively, *Securities Regulation and Freedom of the Press: Toward a Marketplace of Ideas in the Marketplace of Investment*, 60 WASH. L. REV. 843, 847 (1985) (arguing for more First Amendment protection for securities promotions); Burt Neuborne, *The First Amendment and Government Regulation of Capital Markets*, 55 BROOK. L. REV. 5, 37 (1989) (criticizing the Supreme Court's approach to commercial speech regulation); Michael E. Schoeman, *The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933*, 41 BUS. LAW. 377 (1986) (arguing that government restrictions on securities advertising is unconstitutional); Wolfson, *supra* note 8, at 205–66 (arguing that there is no distinction between commercial speech and political expression); Elizabeth Jean Holland, Note, *Proxy Preclearance and*

the wake of the Supreme Court's heightened vigilance in favor of commercial speech,[115] there has been a renewed interest.[116]

Commentators have justified First Amendment scrutiny on several different grounds. Nicholas Wolfson, for example, has argued that the speech affected by securities regulation is indistinguishable from fully protected, high value political speech, and thus should be evaluated under strict scrutiny.[117]

Aleta Estreicher partially disagreed, claiming that some speech affected by securities regulation was distinguishable from high value speech based not on the speaker's motive, but on the message's content.[118] If "the message communicates a point of view or espouses something other than a commercial transaction,"[119] then it may be regulated "under principles that would be applicable to any other expressive communication, whether it be political, religious, artistic or economic in content."[120]

Burt Neuborne proposed that securities regulation should be evaluated under the First Amendment based on a listener-centered approach similar to that used to justify First Amendment scrutiny of commercial speech regulations, rather than to protect the corporate speaker's interests.[121] Under this approach, regulations mandating disclosure are generally acceptable, as long "as the forced disclosure is limited to information that is genuinely necessary to permit hearers

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the First Amendment: The Unconstitutionality of Rule 14a-6, 9 CARDOZO L. REV. 1555, 1557 (1988) (arguing that proxy preclearence is unconstitutional); Clark A. Remington, Note, *A Political Speech Exception to the Regulation of Proxy Solicitations*, 86 COLUM. L. REV. 1453, 1468–71 (1986) (suggesting that certain proxy solicitations deserve more protection); Russell Gerard Ryan, Note, *The Federal Securities Laws, the First Amendment, and Commercial Speech: A Call for Consistency*, 59 ST. JOHN'S L. REV. 57, 62 (1984) (concluding that SEC regulation of commercial speech is unconstitutional).

115. *See supra* notes 40–45 and accompanying text.

116. Lloyd L. Drury, III, *Disclosure is Speech: Imposing Meaningful First Amendment Constraints on SEC Regulatory Authority*, 58 S.C. L. REV. 757, 758 (2007) (discussing Google's recent violation of "an SEC-imposed quiet period"); *Free Speech Protections for Corporations*, *supra* note 40, at n.111 (discussing securities regulation as a "promising but undeveloped avenue through which the Court might have, or might yet, parse the distinction between commercial and political speech is the realm of securities regulations"); Page & Yang, *supra* note 13, at 8; Siebecker, *supra* note 3, at 616.

117. WOLFSON, *supra* note 8, at 157.

> The rationale for the supposed constitutionality of such government restraint turns on notions of the difference between commercial speech and political or artistic speech or on some notions of regulation of professionals in the securities industry. On analysis, the distinctions between commercial speech and other forms of expression, and notions of professional regulation do not stand up. . . . [S]peech regulated by the SEC is not commercial speech as traditionally defined, and is indistinguishable from fully protected speech.

Id.; *see also* Wolfson, *supra* note 8, at 256–66 (arguing that no distinction exists between commercial speech and political expression).

118. Estreicher, *supra* note 114, at 259.

119. *Id.* at 258.

120. *Id.* at 259.

121. Neuborne, *supra* note 114, at 51–62.

to make informed and autonomous choices."[122] By contrast, restrictions on speech before and after a prospectus has been filed should not be permissible.[123]

Several commentators (or litigants) have responded with arguments against the First Amendment's application to securities regulation.[124] These responses were largely based either on distinctions between the capital markets and securities on the one hand and other markets and their "products" on the other, or due to predictions regarding the impact on capital markets if securities regulations were struck down.[125]

This last argument in particular appears on its face less like an argument about whether the First Amendment should be applied to securities regulation in the first instance and more like an argument about why a First Amendment challenge should fail. These are really two different questions: "[W]hether there are constitutional constraints on Congress's power to regulate the interstate distribution and trading of corporate securities and, if so, whether the existing regulatory scheme exceeds those constraints."[126] The answers depend, to use Frederick Schauer's terms, on the First Amendment's "coverage" and "protection," or its "[w]idth and [d]epth."[127]

The answer to the first question (does the First Amendment apply to securities regulation?), however, may well depend on the answer to a second question (would some securities regulations be struck down?), which would turn

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122. *Id.* at 61–62. Neuborne's standard is similar to the Court's definition of materiality. *See supra* notes 86–57.

123. Neuborne, *supra* note 114, at 61.

124. *See supra* notes 5, 15, and 47; *see also* Robert W. McChesney, *The New Theology of the First Amendment: Class Privilege over Democracy*, 49 MONTHLY REVIEW 17, 18 (arguing that democratic interpretation of the First Amendment should not extend its protection to commercial activities); Arthur R. Pinto, *The Nature of the Capital Markets Allows a Greater Role for The Government*, 55 BROOK. L. REV. 77, 80 (1989) (arguing that First Amendment analysis should not apply to securities); Siebecker, *supra* note 3, at 621 (arguing that First Amendment protection should not extend to securities regulation based on an institutional approach); Brief of Law Professors, *supra* note 47, at 16–22. I am not addressing here the more generalized arguments against the First Amendment's application to commercial speech. *See* sources cited *supra* note 9. To reiterate, my more modest goal is to address the arguments against the First Amendment's application to securities regulation, given the backdrop of the existing commercial speech doctrine.

125. *See, e.g.*, Siebecker, *supra* note 3, at 651 (focusing "on the effects that granting full First Amendment protection to politically tinged corporate speech would have on the system of mandatory disclosure and reporting under existing securities laws").

126. Dooley, *supra* note 34, at 335.

127. Michael Herz, *Nearest to Legitimacy: Justice White and Strict Rational Basis Scrutiny*, 74 U. COLO. L. REV. 1329, 1340 (2003) (italicized in original). Typically the First Amendment's coverage is deeper than it is wide. *Id.* at 1341. For example, Herz notes that Justice Black was commonly known as a "First Amendment absolutist," meaning that he was fiercely protective of speech. *Id.* at 1341–42 (internal quotations omitted); *see, e.g.*, Beauharnais v. Illinois, 343 U.S. 250, 274–75 (1952) (Black, J., dissenting) (stating that the First Amendment "'absolutely' forbids" laws abridging the freedom of speech "without any 'ifs' or 'buts' or 'whereases'"). This strong protection was provided, however, only if Justice Black thought that the speech was covered by the First Amendment; because he frequently thought it was not covered, he could be said to favor a narrow but deep First Amendment. Herz, *supra*, at 1340–41. *See also* McChesney, *supra* note 124, at 22 (observing that "even the most strident 'absolutist' cannot avoid determining what speech qualifies" for First Amendment protection).

in part on the likely consequences if securities regulations were struck down. Schauer has also suggested that securities regulation (and other speech that is not yet covered by the First Amendment)[128] is largely not covered due to nonlegal factors:

> [N]onlegal factors, far more than legal ones, determine which opportunistic claims to First Amendment attention will succeed and which will not. Legal doctrine and free speech theory may explain what is protected within the First Amendment's boundaries, but the location of the boundaries themselves—the threshold determination of what is a First Amendment case and what is not—is less a doctrinal matter than a political, economic, social, and cultural one.[129]

Accordingly, he suggests that looking at "the political, sociological, cultural, historical, psychological, and economic milieu in which the First Amendment exists and out of which it has developed" might be more useful in determining its boundaries than any underlying doctrinal theory.[130] If Schauer is correct, this implies that the necessity of regulations affecting speech to the effective functioning of the capital markets would matter greatly in determining whether the First Amendment should reach securities regulation.

A. *Information-Dependent Nature of Securities*

A group of arguments against the First Amendment's application to securities regulation are based on the claim that there are distinctive information-related features of the capital markets and securities that distinguish them from other markets and goods. Arthur Pinto argues that even given the "development of the first amendment in the commercial speech area, its application to securities law and the capital markets is inappropriate because

128. John Fee lists some areas of law "that routinely regulate the content of private expression in specific contexts, which are not typically thought to infringe the First Amendment. These include antitrust law, securities law, labor law, workplace harassment law, rules of evidence, copyright and trademark law, panhandling restrictions, regulation of building architecture, court rules governing the citation of unpublished precedent, and rules of decorum in public meetings." John Fee, *Speech Discrimination*, 85 B.U. L. REV. 1103, 1147–48 (2005) (footnotes omitted).

129. Schauer, *supra* note 5, at 1765 (emphasis omitted).

130. *Id.* at 1787. Schauer in fact recommends, as an additional layer of First Amendment analysis, an institutional approach in which courts would be sensitive to such factors. Frederick Schauer, *Towards an Institutional First Amendment*, 89 MINN. L. REV. 1256, 1263 n.43 (2005) (specifying broadcasting and military speech as two situations where the courts already take an institutional approach); *see also* BeVier, *supra* note 15, at 328 (arguing that First Amendment analysis depends on the market for information in each institutional setting); Daniel Halberstam, *Commercial Speech, Professional Speech, and the Constitutional Status of Social Institutions*, 147 U. PA. L. REV. 771, 857 (1999) (suggesting that "professional and commercial speech [should be] viewed as bounded speech institutions"). Michael Siebecker has applied Schauer's institutional analysis to conclude that the First Amendment should not apply to securities regulation. *See infra* notes 186–87 and accompanying text.

speech in the market differs from other forms of commercial speech."[131]

The capital market is different from "consumer" or "products" markets, according to Pinto, because of the nature of securities.[132] He draws a distinction between choosing to buy a share of General Motors and choosing to buy a General Motors car.[133] A share is intangible and "cannot be consumed, inspected, or verified."[134] Its value depends in large part on firm-specific information, much of which comes directly from the company.[135] By contrast, a

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131. *Pinto*, *supra* note 124, at 81. Pinto does in fact concede that proxy and tender offer rules may trench upon high value political speech, and thus warrant a "greater justification." *Id.* at 100. More generally, he accepts that "[t]he vast majority of battles for control . . . deal fundamentally with issues of an investor's economic interests that may have a political dimension." *Id.* He concludes that if these "battles are 'inextricably intertwined' with traditionally protected speech, then the SEC should limit its reach." *Id.* at 101 (quoting Riley v. Nat'l Fed'n of the Blind of N.C., Inc., 487 U.S. 787, 796 (1988)). He does not, however, explain whether this would be traditional strict scrutiny or some intermediate scrutiny requiring a "greater justification" (i.e., requiring the SEC to have more substantial "ends").

132. *Id.* at 77–88.

133. *Id.* at 83.

134. *Id.* at 83.

135. *Id.* at 83 (observing that the value of "General Motors stock depends upon the investor's ability to demand and receive accurate, complete disclosure about the business from the firm and to verify that information"). Boyer likewise attempts to distinguish speech covered by securities regulation from commercial speech, but on the grounds that securities are contracts. He elaborates:

> The statements that are publicized as part of the disclosure process function as warranties. The prospectus cannot be viewed as a pure advertisement, nor the registration statement as a mere announcement, because the offering is not embodied in an artifact that can be distinguished from the description offered in the documents. The offering consists in the representations made in these documents. Requiring disclosure, thus, is a means of assuring that a security is what it is represented to be, and it assures that there is force and validity to those representations.

Boyer, *supra* note 46, at 483.

Presumably the argument is that when an investor buys a security, what is actually being purchased is determined by everything that must be disclosed: the risk factors, the financial history and management's discussion and analysis of the business, and so on. *Id.* It is much less clear that what is being purchased should also be determined by extraneous information also affected by securities regulation, such as an unrelated press interview with the founder. *See, e.g.*, David Bank, *Disquiet Period: Salesforce.com IPO Is Delayed,* WALL ST. J., May 20, 2004, at C5 (reporting on Salesforce.com's delayed IPO as a result of a *New York Times* interview of the CEO); Kevin J. Delaney et al., *Google IPO May Face New Hurdle*, WALL ST. J., Aug. 13, 2004, at C1 (describing SEC scrutiny of company founders' interview with Playboy magazine). Even more clearly, a company's ads for its products cannot be considered as defining the company's securities. *See supra* notes 95–99 and accompanying text. At most, the argument appears to support only an exemption from the First Amendment for registration statements and prospectuses. In addition, the argument seems even more stretched for a debt security, where what is being sold is a promise to pay interest and repay the principal, and the terms and conditions of the offering are embodied in like the indenture.

Boyer's argument would appear to apply to many things that are typically not securities as well, like life, medical, or car insurance, a mortgage, or even a checking or savings account. It might also apply to any product with a warranty, because when consumers buy such a product they are also buying the credit and performance risk associated with the company delivering on the warranty. Finally, it would also seem applicable to products like commercial software, which actually consist of computer code incomprehensible to the vast majority of users, but which are described in practice by owners' manuals, text help files, or even advertisements. It does not appear to be so much an argument that

car can be evaluated both directly based on a driver's experience and indirectly because experts or auto mechanics can test the vehicle and report their experiences.[136] Fraud in the sales of cars can be readily discovered, whereas discovering fraud in the sales of securities will be much more difficult.[137] In short, "[t]here is a greater potential for fraud and manipulation in a market so dependent upon the seller."[138] Boyer likewise argues that "the heightened risk of

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speech affected by securities regulation should not be covered by the First Amendment, as an argument that the SEC's regulations are permissible to ensure that a sale of a security (like the sale of any good or service) is not misleading.

Boyer also argues that securities are different because the representations that fall within the scope of SEC regulation "inextricably involve conduct: the issuing of securities." Boyer, *supra* note 46, at 484. Relying on *United States v. O'Brien*, 391 U.S. 367, 382 (1968), Boyer claims that such "speech may be denied First Amendment protection" because the "burning of a draft card may metaphorically be viewed as the mirror image of printing a securities prospectus. The same reasoning that permits the state to forbid the former act allows it to require the disclosure entailed by the latter." Boyer, *supra* note 46, at 484. He reads *O'Brien* together with *Zauderer* to "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." *Id.* at 485.

First, the noncommunicative conduct is the issuance of securities, but this is only relevant for the speech affected under the '33 Act. Other securities regulation affects speech that is not linked to the initial issuance of securities. Second, the speech and conduct, unlike burning a draft card, hardly seem inextricably intertwined; the state can simply pursue the conduct. *See* Bd. of Trs. of State Univ. of N.Y. v. Fox, 492 U.S. 469, 474 (1989) (quoting *Riley*, 487 U.S. at 796). Third, even though Boyer asserts that this activity may be denied First Amendment protection, the activity actually *is* protected based on a four-part test that closely resembles the *Central Hudson* test applied to commercial speech. *See O'Brien*, 391 U.S. at 377 ("[W]e think it clear that a government regulation is sufficiently justified if it is within the constitutional power of the Government; if it furthers an important or substantial governmental interest; if the governmental interest is unrelated to the suppression of free expression; and if the incidental restriction on alleged First Amendment freedoms is no greater than is essential to the furtherance of that interest."); *see also Making Sense of Hybrid Speech*, *supra* note 45, at 2837, 2845 (noting how the *Central Hudson* and *O'Brien* four-factor tests closely parallel each other).

136. Pinto, *supra* note 124, at 83.

137. *Id.*

138. *Id.* at 84. Pinto claims that the securities laws are a form of consumer protection legislation, as "Congress was particularly concerned with restoring the confidence of investors in the capital markets. . . . Federal securities laws are aimed at preventing manipulation of the markets and providing full disclosure, which would often not be otherwise available, for those who invest and trade in securities." *Id.* at 82. The argument, even if Pinto's claim is accepted, really only implies that the purpose of the laws should be taken into account by courts when judging securities regulation under the First Amendment, just as it is with other consumer protection statutes. Thus state regulation of misleading or unduly assertive sales practices or advertisements have survived First Amendment challenge. *See* Fla. Bar v. Went For It, Inc., 515 U.S. 618, 635 (1995) (upholding a thirty day waiting period to protect accident victims from lawyers using direct mail solicitations); Bates v. State Bar of Ariz., 433 U.S. 350, 383 (1977) (holding that "advertising by attorneys may not be subjected to blanket suppression" but that "[a]dvertising that is false, deceptive, or misleading of course is subject to restraint"); *see also* Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 772 n.24 (1976) (noting that the state may require advertisements to "appear in such a form, or include such additional information, warnings, and disclaimers, as are necessary to prevent its being deceptive"); Turner Broad. Sys., Inc. v. FCC, 520 U.S. 180, 185, 224–25 (1997) (applying the First Amendment to provisions of the Cable Television *Consumer Protection* and Competition Act of 1992 but holding that it passed constitutional muster). Many commentators, however, strongly reject the claim that securities regulations are about consumer protection. *See, e.g.*, Zohar Goshen & Gideon

fraud and the market's need for accurate information overshadow assertions that the First Amendment applies."[139]

More generally, Pinto contends that securities are "credence goods," meaning their "qualities are difficult to discover by inspection or use, thus rendering the buyer dependent upon the seller."[140] The analogy, however, is weak. Typically credence goods or services involve situations where ex post the buyers do not know *both* whether they needed the good or service and whether the good or service was even provided.[141] The quintessential example involves auto repairs. The car owner may not know if she needed a new part or simply an adjustment, and assuming the repair works, she may not even know what service the mechanic actually provided.[142] Another example involves medical procedures; thus, doctors may perform fewer unnecessary procedures on other doctors, in theory at least, because other doctors are more likely to know whether the procedure is actually necessary.[143]

A buyer of securities, however, typically knows she needs or wants the security (i.e., a return on her investment) and actually owns the security but is only uncertain of the security's value, or more precisely, whether its market value is correct.[144] This uncertainty involves a matter of degree, however, rather

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Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 713 (2006) ("Any serious examination of the role and function of securities regulation must sidestep the widespread, yet misguided, belief that securities regulation aims at protecting the common investor. Securities regulation is not a consumer protection law.") (footnote omitted).

139. Boyer, *supra* note 46, at 489 (mergers & acquisitions context); *see also* BeVier, *supra* note 15, at 328–29 (arguing that the securities market and its market for information are different from the consumer goods market (and its market for information), and both markets in turn are different from the political market (and its market for information)).

140. Pinto, *supra* note 124, at 84 (citing Ellen R. Jordan & Paul H. Rubin, *An Economic Analysis of the Law of False Advertising*, 8 J. LEGAL STUD. 527, 530-31 (1979)). This is in contrast to "inspection" or search goods "whose quality and fitness are ascertainable by inspection before sale" such as clothing or "'experience' goods whose qualities are revealed by use" such as food. *Id. See generally* Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 68–72 (1973) (discussing how search, experience, and credence qualities of goods affect consumer behavior). Although the term is typically *credence good*, examples commonly listed in the literature involve doctors, lawyers, cab drivers and auto mechanics and might be better described as *credence services*. *See, e.g.*, *Sawbones, Cowboys and Cheats*, THE ECONOMIST, April 15, 2006, at 78 (identifying classes of experts whose services represent "'credence goods,' because customers take it on faith that the supplier has given them what they need, and no more").

141. Uwe Dulleck & Rudolf Kerschbamer, *On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods*, 64 J. ECON. LIT., Mar. 2006, at 5, 7.

142. *Id.* at 5–6.

143. *Sawbones, Cowboys and Cheats*, *supra* note 140 (discussing a series of Italian studies performed by Gianfranco Domenighetti that found the more sophisticated the patient, the fewer operations surgeons performed).

144. Buyers who do not know what securities they need can use an investment adviser and are then protected by the adviser's fiduciary duties to them. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–92 (1963).

than kind; *all* investments are uncertain in some respects,[145] regardless of the amount of disclosure. With less (or less useful) disclosure, the investor will be more likely to be uncertain about firm-specific risks.[146] Furthermore, although investors will likely want some disclosure, they desire only those disclosures where the benefits exceed the costs.[147]

To the degree Pinto's analysis is correct, one must remember that investors are likely to pay more for shares in a company that discloses information, and commits to disclose information in the future, as opposed to a company which does not. Companies, in fact, have a strong incentive to credibly disclose relevant information in order to lower their cost of capital.[148] At least in the

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145. Even U.S. Treasury bills, commonly referred to as a risk-free investment, face credit risk because there is a non-zero possibility that the government will default. *See, e.g.*, *Risk-Free Bonds Aren't*, Posted by Eliezer Yudkowsky, 06:30 p.m., June 22, 2007, http://www.overcomingbias.com/2007/06/risk-free-bonds.html#more.

146. There is a similarity to product markets here too. A consumer buying a car may believe that it will be reliable and will last ten years, but in fact it may last only six years or as many as fifteen years, and it may need few or many repairs. Whether the consumer's belief was justified, however, will not be known for many years. Likewise, an investor may believe that the company will pay all interest and principal due on a ten-year bond, but only time will actually demonstrate that. One can in fact argue that uncertainty is *more* important in the product market because diversification is harder (i.e., many people cannot afford to buy two cars). In the capital market investors can diversify easily, which means firm-specific risk goes uncompensated. *See infra* notes 163–66 and accompanying text.

147. *See, e.g.*, HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT (2006) ("Although investors do not like to be defrauded and do want some regulation, they will find such regulation valuable only if the benefit from reduced fraud is greater than the cost of compliance by the firms they invest in."). Former Treasury Secretary Bob Rubin recognized the tradeoff: "Our society seems to have an increased tendency to want to eliminate or minimize risk, instead of making cost/benefit judgments on risk reduction in order to achieve optimal balances." Press Release, Henry M. Paulson, Treasury Sec'y, U.S. Dep't of the Treasury, Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets, Economic Club of New York, (Nov. 20, 2006) (quoting former Treasury Secretary Bob Rubin), *available at* http://www.ustreas.gov/press/releases/hp174.htm; *see also* Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 334 (2003) (noting that "[i]nvestors pay dearly for [the U.S. regulatory] infrastructure but do not receive the safeguards and other protections they are told they might receive"). After all, if one really wanted to deter investment fraud, one could impose draconian punishments. *See, e.g.*, *Chinese Businessman Gets Death for Bogus Ant-Breeding Scheme*, ASSOCIATED PRESS, Feb. 15, 2007, *available at* http://www.foxnews.com/story/0,2933,252141,00.html (reporting that an executive was sentenced to death for defrauding investors). Concededly, corporate disclosure may have benefits for parties other than investors; however, there is little research on this matter.

148. This point has been made frequently. Two prominent analyses are Frank H. Easterbrook & Daniel R. Fischel's *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 683 (1984), which argued that firms have an incentive to disclose information because "[i]nvestors [faced with a firm's silence] would assume the worst, [reasoning] that if the firm had anything good to say for itself it would do so," and Steven A. Ross's *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177, 183–88 (Franklin Edwards ed., 1979), which argued that in a competitive market managers have an economic incentive to distinguish their firms by disclosing information. This view has also been extensively criticized, in that even though issuers may have incentives, information may still be underdisclosed due to externalities. *See, e.g.*, Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1393–95 (1999) (arguing that an "issuer

initial public offering context, "there is strong evidence that investor informational demands often propel issuers to provide disclosure at levels beyond that mandated—as a private, contractual matter."[149] Peter Spencer, although agreeing that all financial assets and services should be classified as credence goods, also claims that investors "only buy equities if we believe that the company is sound and we trust the management," which will depend in large part on disclosure.[150] In addition, even for credence goods and services, customers will typically know of the supplier's incentives, and assuming they act on this knowledge, some of the problems with such goods are eliminated.[151]

In some ways there is a useful analogy between shares and used cars. As George Akerlof explained in his famous article, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*,[152] given asymmetrical information (where one party has more and better information than the other), less valuable used cars would drive more valuable used cars from the market, resulting in the market's collapse.[153] Akerlof's analysis applies to most markets, because most markets involve some level of asymmetric information.[154] The fact that there is a thriving market for used cars simply means that buyers and sellers have found other ways of reducing the information asymmetry, such as bonding and warranties.[155] Similarly, it is in the interests of both investors and issuers to

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choice system" of disclosure would result in less disclosure than a mandatory system and that the proponents of "issuer choice" should produce empirical evidence that mandatory disclosure causes more harm than benefits).

149. Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 4 (1999).

> U.S. issuers have increasingly shunned public offerings in favor of private offerings to avoid the costs of mandatory disclosure and heightened liability. But in making private offerings, many issuers disclose voluntarily at the same or higher levels compared to regulated registered offerings. Moreover, issuers in public offerings often disclose information voluntarily beyond that required so as to increase investor confidence. In short, the disclosure demands of investors and their intermediaries—not the distortions of mandatory disclosure—govern the supply of information in securities offerings.

Id. at 5–6 (citations omitted); *see also* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 746 (1984) (agreeing that the "theory of voluntary disclosure does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all primary distributions" but claiming that the theory is "far less persuasive" when applied to the disclosure regulated by the '34 Act).

150. PETER SPENCER, THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS 8 (2000).

151. See Dulleck & Kerschbamer, *supra* note 141, at 7–8.

152. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970). George Akerlof was awarded the 2001 Prize in Economics in memory of Alfred Nobel for this article.

153. *Id.* at 490.

154. *See* George A. Akerlof, *Writing the "The Market for 'Lemons": A Personal and Interpretive Essay*, Nov. 14, 2003, http://nobelprize.org/cgibin/print?from=/nobel_prizes/economics/articles/akerlof/index.html.

155. Akerlof, *supra* note 152, at 499.

reduce the information asymmetry.[156] Mandatory government regulation is not necessarily required to reduce the information problem—contracting and information intermediaries (monitors) can also work.[157]

A company can ensure that information is monitored or otherwise vouched for by underwriters, accountants, bankers, lawyers, or even insurers.[158] For example, a recent study demonstrated that bank loans, through bank monitoring of companies, add value for shareholders.[159] Another study found that even "in the absence of mandated disclosures, capital markets can discriminate between firms with high and low probabilities of internal control problems" based on the

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156. This mutual incentive between buyer and seller helps explain why it is rare for a buyer to be denied the opportunity to test drive a car before purchasing.

157. Pinto recognizes that effective monitors are important, but argues that this may be too costly since the issuers are the source of the information. Pinto, *supra* note 124, at 85. This assumes that for some reason the issuers are opposed to the monitoring, or put differently, that the benefits of committing fraud are higher than the benefits of accurate stock information. He also baldly asserts that there is a "lack of effective private monitors in the capital markets." *Id.* at 87.

158. *See, e.g.*, Larry E. Ribstein, *Limited Liability of Professional Firms After Enron*, 29 J. CORP. L. 427, 440 (2004) ("Professional firms' reputations can bond their promises . . . to monitor clients on behalf of investors and others. Large professional firms in effect rent their reputations to their clients . . . ."). Financial statements are, of course, audited by outside accounting firms. This may happen even if it were not mandated by the securities laws. In the Netherlands, 84% of listed firms chose to have their financials audited, even though it was not mandatory. *See* Willem Buijink, *Evidence-Based Financial Reporting Regulation*, 42 ABACUS 296, 296 (2006). Furthermore, as others have suggested, companies could purchase insurance for the accuracy of their financial statements. *See, e.g.*, Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 427 (2004) (suggesting that "[f]inancial statement insurance can be created as an optional alternative to traditional financial statement auditing"). "Bad" financial statements then will not crowd out "good" financial statements.

Of course, auditing, like other professional services, is also a credence good, because investors will not be confident of an audit's quality based on anything other than the auditor's reputation. *See* Ribstein, *supra*, at 438–39 (noting that reputation acts as a bond that provides a penalty independent of a legal proceeding). This helps explain the substantive rules requiring auditor independence. Qualifications of Accountants, 17 C.F.R. § 210.2-01 (2006) (setting forth standards for accountant auditor independence); Schedule 14A Information Required in Proxy Statement, 17 C.F.R. § 240.14a-101(9) (2006) (requiring disclosure of certain aspects of the relationship between registrant companies and their independent public accountants); 15 U.S.C. § 78j-1(m)(3) (Supp. 2004) (providing audit committee standards).

159. Joanna M. Shepherd, Frederick Tung & Albert H. Yoon, *Cross-Monitoring and Corporate Governance* (Jan. 16, 2007), *available at* http://ssrn.com/abstract=957627 (finding "strong evidence that bank monitoring adds value"). "[S]hareholders are not the only constituency concerned with managerial agency costs. Given the thick web of firms' contractual commitments, it should not be surprising that other financial claimants may also attempt to control agency costs in their contracts with the firm." *Id.* at 1. Previous studies had confirmed higher stock returns to companies announcing the receipt of bank loans. *See, e.g.*, Charles J. Hadlock & Christopher M. James, *Do Banks Provide Financial Slack?*, 57 J. FIN. 1383, 1414 (2002) (finding that "firms who exhibit small preannouncement stock-price run-ups and those with high stock return volatility are relatively more likely to announce new bank loans"). The announcement may have led to higher returns on a signaling theory that the bank obtained positive private information before approving the loan. Shepherd, Tung, and Yoon's study shows that "bank monitoring improves firm value in general." Shepherd, Tung & Yoon, *supra*, at 29; *see also* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1078 (1995) ("The screening and monitoring activities of a lender produce externalities that benefit other creditors and other stakeholders.").

firms' audit fees.[160] Self-regulation is another method.[161] Optional government regulation (i.e., allowing a corporation to choose whether to be regulated by the SEC or perhaps state regulators) would be another alternative method.[162]

The argument that government regulation is required is also called into question by the changing nature of investment in the securities market. First, private investors now directly own a relatively small percentage of securities.[163] Because securities are now more likely to be institutionally owned, the need to protect the small investor has declined. Second, equities are now much less likely to be selected individually and much more likely to be held as part of a "large portfolio of stocks weighted by their market capitalization,"[164] such as index funds. Battacharya and Galpin report that the fraction of U.S. stock trading volume explained by value-weighted portfolios has increased from less than one-third in the 1920s to more than two-thirds today.[165] Modern financial theory supports the use of this passive indexing approach,[166] which also results in the irrelevance of firm-specific risk.

Even the SEC appears to concede that mandatory disclosure is unnecessary in those situations where investors are assumed to be able to fend for themselves. Small issues, securities sold under Rule 144A, and stocks traded on the pink sheets all do not face the same disclosure requirements as other issues.[167] In other words, not all securities are so different from other goods and services that mandatory disclosure is a necessity.

In addition, not only is government mandated disclosure (and occasional restrictions of disclosure) of information not necessary to prevent fraud, it also is not sufficient. Disclosure is "useful only if market mechanisms are in place that are capable of observing and interpreting the information."[168] The Enron

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160. Aloke Ghosh & Martien Lubberink, *Timeliness and Mandated Disclosures on Internal Controls Under Section 404* (Sept. 2006), *available at* http://ssrn.com/abstract=931896.

161. Self-regulation was the dominant form of regulation in British capital markets until as recently as May 1997. SPENCER, *supra* note 150, at 32. Other industries, such as law, medicine, and accounting, have all developed methods of self-regulation, "backed up in recent years by the force of law." *Id.* at 32–34; *see also supra* note 2 and accompanying text (discussing the regulation imposed by the NYSE).

162. *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2365 (1998) (proposing a securities regime where companies choose between federal and state regulation). A recent Court decision suggests that a state actor may constitutionally restrict a voluntary participant's First Amendment rights. *See* Tenn. Secondary School Athletic Ass'n v. Brentwood Academy, 127 S. Ct. 2489, 2495–96 (2007), *available at* 2007 WL 1773196.

163. The Federal Reserve Board reports that as of March 31, 2007, the household sector directly owns less than 26% of corporate equities and less than 12% of corporate bonds. *See* Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, First Quarter 2007, at 89 tbl.L.212, 90 tbl.L.213 (2007), *available at* http://www.federalreserve.gov/releases/z1/current/z1.pdf.

164. Utpal Bhatacharya & Neal Galpin, *The Global Rise of the Value-Weighted Portfolio* 1, AFA Chicago Meetings Paper (Mar. 2007), *available at* http://ssrn.com/abstract=849627.

165. *Id.* at 3.

166. BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 402–08 (9th ed. 2007).

167. Ironically, investors in the so-called small issues are often least able to fend for themselves. *See* Palmiter, *supra* note 149, at 36.

168. Macey, *supra* note 147, at 330.

collapse exemplifies this failure of market mechanisms.[169] As Malcolm Gladwell argued in a recent article, Enron was not primarily about insufficient or inaccurate disclosure.[170] Rather, the information was publicly disclosed, waiting to be put together.[171] The market, however, simply did not assimilate this disclosed information, at least not quickly.[172] Instead, the *Wall Street Journal* published an article in September 2000, which led a financier to short the stock in November, followed by a story in *Barron's* in March 2001, which led to more analysts and journalists examining the company.[173] As Gladwell notes, whereas to break the Watergate story the reporters needed an inside source, to break Enron the reporter merely called an accounting professor and met directly with Enron financial officials.[174]

Voluminous or confusing disclosure can overwhelm and mystify rather than inform.[175] Enron may prove "that in an age of increasing financial complexity the 'disclosure paradigm'—the idea that the more a company tells us about its

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169. *Id.* at 331 (observing that "[i]n the Enron collapse, the U.S. mandatory reporting system worked fairly well").

170. Malcolm Gladwell, *Open Secrets: Enron, Intelligence, and the Perils of Too Much Information*, NEW YORKER, Jan. 8, 2007, at 46.

171. *See id.* at 46. (quoting a reporter, Jonathan Weil, who, after looking at Enron's public filings, stated that it took him about a month to figure out the company's financial situation because "[t]here was a lot of noise in the financial statements, and to zero in on [the cash-flow issue] you needed to cut through a lot of that.").

172. *See id.* at 46–47 (detailing how the information became known to the market); Macey, *supra* note 147, at 331 (noting that "the market did an astonishingly poor job of both interpreting Enron's disclosures and 'decoding' the information contained in the trades conducted by Enron insiders."); Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 19 (2004) (arguing that "Enron's . . . transactions are [] so complex that less than a critical mass of investors can understand them in a reasonable time period").

173. *See* Gladwell, *supra* note 170, at 46–47, Macey, *supra* note 147, at 339–40.

174. Gladwell, *supra* note 170, at 47–48. He adds, "[Y]ou can't blame Enron for covering up the existence of its side deals. It didn't; it disclosed them." *Id.* at 49.

175. *See generally* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003) (examining the impact of information overload on securities regulation). Gordon Smith, a corporate lawyer turned law professor, observed the following:

> When I was writing disclosure, I discovered that more isn't always better. Indeed, some clients wanted more because they figured they could overwhelm the market. I think they were right. We often view the market as a supercomputer, and it is in a way, but the market still relies on individuals to plow through the disclosure, and a lot of it is almost impenetrable or unfathomable.

Posting of Gordon Smith to Conglomerate Blog: Business, Law, Economics & Society, http://www.theconglomerate.org/2005/06/the_future_of_s.html (June 3, 2005, 12:09 EST). "Companies have every incentive to disclose in high volume, not only because it provides litigation protection but because negative disclosures are less transparent when they appear in a se[a] of other information." *Id.* posted (June 3, 2005, 13:02 EST). The Enron situation was no doubt exacerbated by the complexity of the underlying situation. Gladwell notes that members of Enron's board, Arthur Andersen's field staff, and Enron's Chief Financial Officer himself likely did not fully understand the deals Enron was doing. Gladwell, *supra* note 170, at 49.

business, the better off we are—has become an anachronism."[176] Some commentators have gone even further, demonstrating that under some plausible assumptions, mandating increased disclosure of issuers may in fact have the unintended consequence of actually *increasing* fraud.[177]

Finally, even if Pinto is right that securities are credence goods that particularly depend on government mandated disclosure,[178] this contention does not imply that the First Amendment should be inapplicable. News produced by media corporations like the New York Times Company involves the type of speech most protected by the First Amendment, but news is also a credence good.[179] Consumers are usually unable to evaluate whether the news is "accurate and impartial and [whether] it contains the most significant happenings of the day."[180] The *New York Times* claims on its front page that it includes "All the News That's Fit to Print," but this is very difficult to verify. The inability of consumers to evaluate news may in fact "invite fraud,"[181] but nobody argues that this should affect the applicability of the First Amendment.[182]

Rather, even if there really is a heightened risk of fraud in the securities context that uniquely requires government mandated disclosure, this argument more properly addresses whether the regulations can withstand First Amendment scrutiny and not than whether there should be First Amendment scrutiny in the first instance. Furthermore, this does not mean that government mandated prohibitions of nonfraudulent speech should be exempt.

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176. Gladwell, *supra* note 170, at 50 (citing Steven Schwarcz, a professor at Duke Law School); *see also* Schwarcz, *supra* note 172, at 11–17 (arguing that disclosure may be insufficient when the underlying transactions are too sophisticated for even institutional investors to understand); Macey, *supra* note 147, at 349 (observing that the U.S. system of mandatory disclosure "failed miserably in Enron, and that failure appears to be pervasive rather than isolated").

177. *See* Paul Povel et al., *Booms, Busts, and Fraud*, 20 REV. FIN. STUDIES (forthcoming 2007), *available at* http://ssrn.com/abstract=956209 (arguing that requiring issuers to disclose more information could have the unintended consequence of increasing fraud).

178. *See supra* notes 140–51 and accompanying text.

179. *See, e.g.*, Charles Davis & Stephanie Craft, *New Media Synergy: Emergence of Institutional Conflicts of Interest*, 15 J. MASS MEDIA ETHICS 219, 224 (2000) ("News is a 'credence good,' a product that must be consumed on faith alone."); *cf.* Brian Logan & Daniel Sutter, *Newspaper Quality, Pulitzer Prizes, and Newspaper Circulation*, 32 ATLANTIC ECON. J. 100, 101 (2004) ("News has the character of an experience good—where consumers do not observe quality before consuming the good—or a credence good—where the quality is not discernible even after consumption."); Mark R. Patterson, *On the Impossibility of Information Intermediaries* 6 (Fordham Univ. Sch. of Law, Law and Economics Research Paper No. 13, 2001), *available at* http://papers.ssrn.com/abstract=276968 (pointing out that the *Wall Street Journal* is a credence good, because its "evaluations and even its facts, may be inaccurate"). More generally, information itself is generally a credence good. Patterson, *supra*, at 6.

180. John McManus, *Serving the Public and Serving the Market: A Conflict of Interest?*, 7 J. Mass Media Ethics 196, 198–99 (1992) (concluding that news is a credence good).

181. *Id.* at 196.

182. Concededly the First Amendment includes a press clause; however, this does not serve to distinguish media because as a matter of positive law the press clause actually plays a rather minor role in protecting the freedom of the press. "Most of the freedoms the press receives from the First Amendment are no different from the freedoms everyone enjoys . . . ." David A. Anderson, *Freedom of the Press*, 80 TEX. L. REV. 429, 430 (2002).

B. Fragile Nature of the Capital Markets

A second set of arguments either explicitly or implicitly claim that bringing securities regulation within the ambit of the First Amendment will result in widespread harm to the capital markets.[183] U.S. capital markets are often seen as the best and most successful in the world largely because of the SEC's disclosure regulations.[184] Any constitutional threat to these regulations would be highly problematic. Thus the law professors' amicus brief in the Siebel Systems case claimed that merely applying anything more than rational review to the regulation at issue would be "an unprecedented and destabilizing step" with "profound" consequences.[185]

If some securities regulations were struck down these consequences would be even worse. Michael Siebecker, for example, recently argued that if securities regulation were subject to high-level First Amendment scrutiny,

> [p]rivate causes of action for securities fraud currently recognized by the Supreme Court would lose their theoretical underpinnings, and the system of forced public transparency for public corporations and sales of securities would become muddied by political maneuvering. Investors could be left foundering without reliable information upon which to base investment decisions, and gross market inefficiencies could potentially result if market prices rested on infirm or false factual assumptions.[186]

He concludes, "Adequate regulation . . . remains essential to secure the

183. *See, e.g.*, Boyer, *supra* note 46, at 495 (arguing that the First Amendment should be inapplicable to securities regulation "when disclosed information assists the market and when the disclosure process creates and stabilizes investment vehicles").

184. *See, e.g.*, Robert Daines & Charles M. Jones, Truth or Consequences: Mandatory Disclosure and the Impact of the 1934 Act 4 (Jan. 2007) (on file with author) ("Commentators frequently point to US legal rules on mandatory disclosure and its vigorous public and private enforcement as helping to create 'liquidity, reducing capital costs and making fair market prices possible.'" (citations omitted)); Martin Shubik, *Corporate Control, Efficient Markets, and the Public Good*, *in* KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 31, 33–34 (John C. Coffee, Jr. et al. eds., 1988) ("The success of the functioning of possibly the most efficient market known, the New York Stock Exchange, has been in part due to a careful formalization of the rules of the game by its board of governors and by the Securities and Exchange Commission.").

185. *See, e.g.*, Brief of Law Professors, *supra* note 47, at 16, 21. As a foundational matter, the mere uncertainty associated with a possible constitutional challenge may be harmful to the markets. This is true, however, only to the degree that investors (1) deem the constitutional challenge likely to be successful, (2) perceive the regulations as being more beneficial than harmful, and (3) do not believe that private solutions could be reached. In addition, the antifraud provisions of securities regulation would not be at risk.

186. Siebecker, *supra* note 3, at 618; *see also* SEC v. Wall St. Publ'g Inst., Inc., 851 F.2d 365, 373 (D.C. Cir. 1988) ("If speech employed directly or indirectly to sell securities were totally protected, any regulation of the securities market would be infeasible.").

multifarious benefits that securities provide to individuals, corporations, and governments" and is necessary "to ensure[] the integrity of the U.S. capital markets."[187] Similarly, Boyer argues that government mandated disclosure is necessary for the market to function effectively.[188]

This article addresses two main responses. First, is there in fact empirical support for the proposition that disclosure regulations are the cause of the U.S. capital markets' success? Even if disclosure regulations were collectively the cause, it does not imply that all individual provisions are necessarily desirable. Second, this Article also offers a few thoughts on whether securities regulations are likely to be struck down if courts applied the First Amendment.[189] These responses are to some degree interrelated, in that the more the SEC could show harm to the capital markets would result from an invalidation of a securities regulation, the less likely it is that a court would invalidate the regulation.

1. *Empirical Work on Disclosure*

"Perhaps the most hotly-contested debate in the history of securities regulation has been over the need for mandatory disclosure."[190] There are long lists of law review articles by prominent contributors on both sides of the issue, some calling for the repeal of at least some parts of the mandatory disclosure framework.[191] Ultimately, however, this is an empirical question.

Given the volume of research on capital markets, it is surprising how little empirical evidence there really is regarding the effectiveness of the SEC's

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187. Siebecker, *supra* note 3, at 652, 654.

188. Boyer, *supra* note 46, at 487. Boyer claims that government mandated disclosure is necessary to remove "the impediments to full and fair bargaining among all participants." *Id.*

189. For a detailed analysis of the possible results of the judicial application of the First Amendment to securities regulation, see Drury, *supra* note 116, at 779–87.

190. Paredes, *supra* note 175, at 417; *see* Goshen & Parchovsky, *supra* note 138, at 755 ("Probably the most debated issue in securities regulation is whether disclosure duties should be mandatory."); *see also* F. Hodge O'Neal Corporate and Securities Law Symposium, Washington University School of Law, After the Sarbanes-Oxley Act: The Future of the Mandatory Disclosure System (Feb. 21–22, 2003), http://law.wustl.edu/wulq/hodge/2003/.

191. *See, e.g.*, Coffee, *supra* note 149 (providing efficiency-based arguments in favor of mandatory disclosure); Easterbrook & Fischel, *supra* note 148, at 672 (noting "neither the supporters nor the opponents of fraud and disclosure rules have made a very good case"); Fox, *supra* note 148, at 1338 (arguing that "we should reject issuer choice and retain the current mandatory system"); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1454 (1997) (suggesting "regulatory decentralization [rather] than greater centralization"); Palmiter, *supra* note 149, at 4 (arguing for less mandatory regulation); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L. J. 1397, 1399–1402 (2002) (cautioning against a deregulated securities environment); Romano, *supra* note 162, at 2361–64 (1998) (critiquing mandatory federal system); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983) (examining arguments supporting mandatory disclosure and listing books and articles criticizing mandatory disclosure). Some earlier books criticizing the mandatory disclosure system include HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) and GEORGE J. BENSTON, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND USA (1976).

disclosure rules.[192] As the Council of Economic Advisors observed in 2003, "the question of whether SEC-enforced disclosure rules actually improve the quality of information that investors receive remains a subject of debate among researchers almost seventy years after the SEC's creation."[193]

There are some important exceptions, however.[194] Older studies have looked at the impact of the '33 Act on investors in new stock issues, concluding that investors in securities issued shortly before the enactment of the '33 Act received essentially the same returns as those who invested in securities issued shortly after the passage of the '33 Act.[195] Another older study reached a similar

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192. *See, e.g.*, Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACCT. & ECON. 233, 236 (2005) (contributing to "a fairly limited empirical literature on the economic consequences of disclosure regulation"); Daines & Jones, *supra* note 184, at 4 ("[U]nfortunately, . . . we know little about the effects of mandatory disclosure . . . ."); Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405, 414 (2001) ("[S]urprisingly little is known about why financial report and disclosure is regulated in the capital market"); Paul G. Mahoney & Jianping Mei, *Mandatory vs. Contractual Disclosure in Securities Markets: Evidence from the 1930s*, at 4 (Univ. of Va. Law School, the John M. Olin Program in Law and Economics Working Paper No. 25, 2006), *available at* http://law.bepress.com/cgi/viewcontent.cgi?article=1069&context=uvalwps (referring to the "relative dearth of empirical investigation" into public regulation of securities markets); *see also* Willem Buijink, *Evidence-Based Financial Reporting Regulation*, 42 ABACUS 296, 297 (2006) (arguing that mandatory disclosure regulation has not been "evidence based," meaning that policy decisions have not been based on scientific evidence). According to Daines and Jones, one reason for the dearth of empirical investigation is the uniformity imposed on public disclosure by the SEC. Daines & Jones, *supra*, at 6.

193. *See also* COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 2003, 95–97, *available at* http://www.gpoaccess.gov/usbudget/fy04/pdf/2003_erp.pdf, *quoted in* Daines & Jones, *supra* note 184, at 6.

194. In a series of papers comparing regulations among countries, La Porta, Lopez-de-Silanes, Shleifer and sometimes Vishny have concluded that higher levels of investor protection are associated with, among other things, higher stock valuations. Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997). In their most recent paper they concluded that their data from forty-nine countries suggested "the development of stock markets is strongly associated with extensive disclosure requirements and a relatively low burden of proof on investors seeking to recover damages resulting from omissions of material information from the prospectus." Rafael La Porta et al., *What Works in Securities Law?*, 61 J. FIN. 1, 20 (2006); *see also* COUNCIL OF ECONOMIC ADVISORS, *supra* note 193, at 94 (noting that "[s]trong legal institutions are widely recognized as providing a solid foundation for economic growth, including the emergence of a strong corporate sector"). Cross country studies may suffer from many confounds. In addition, the studies looked at several aspects of investor protection of which mandatory disclosure was only one. I am aware of no real world empirical work that examines whether prohibitions on nonmisleading public disclosure either protect investors or result in a more efficient market.

195. Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J. L. & ECON. 613, 638 (1981); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 121 (1964); *see also* Chee W. Chow, *The Impacts of Accounting Regulation on Bondholder and Shareholder Wealth: The Case of the Securities Acts*, 58 ACCT. REV. 485, 514 (1983) (finding only limited evidence that a negative return to investors resulted from the '33 Act); *cf.* Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295, 304–06 (1989) (showing increased dispersion of stock returns before the '33 Act, although this may be attributable to a selection effect).

conclusion regarding the impact of the '34 Act.[196] These studies did not resolve the matter, however, perhaps because of "two shortcomings: (1) a lack of convincing theory justifying the particular measures of stock price performance employed in these studies; and (2) the inability to control for changing market conditions when comparing pre- and post-mandated disclosure periods."[197]

More recently, two studies have examined the impact of the '34 Act on various stock-trading measures. Daines and Jones studied changes in bid-ask spreads, commonly used as a proxy for information asymmetries, at month-end after the first half of 1935.[198] Their two samples were based on common stocks listed on the NYSE or New York Curb exchange or traded over-the-counter.[199] They were "unable to identify specific newly required disclosures that reduce[d] information asymmetries or improved liquidity."[200]

Mahoney and Mei also looked at companies on the NYSE; however, they selected their sample based on whether the company had filed a registration statement between mid-1933 and late 1935.[201] They also divided their sample using a different method, looked at daily return, volume and bid-ask quotation data, and examined the informativeness of earnings reports following the '34 Act. They concluded as follows:

> We find almost no evidence that the new disclosures required by the securities laws—principally having to do with management compensation and large shareholdings—reduced informational asymmetry. We also find no evidence that earnings reports were more informative after enactment of the securities laws. We conclude that the securities laws did not add measurably to the content and credibility of the NYSE's existing disclosure requirements.[202]

In addition, three recent studies have looked at the extension of securities

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196. *See* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 149 (1973) (concluding that "the disclosure provisions of the '34 Act were of no apparent value to investors").

197. Allen Ferrell, *Measuring The Effects of Mandated Disclosure*, 1 BERKELEY BUS. L.J. 369, 372–76 (2004) (providing a detailed critique of these early studies); *see also* Coffee, *supra* note 149, at 718 (describing challenges to the Stigler and Bentson studies); Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 J. BUS. 382, 391 (1964) (criticizing the Stigler study); Seligman, *supra* note 191, at 23 (analyzing problems with the studies).

198. Daines & Jones, *supra* note 184, at 13.

199. *Id.* at 15.

200. *Id.* at 2. Interestingly, they found evidence that the securities acts' enforcement mechanisms were beneficial to those companies that had been disclosing before the implementation of the Acts. *Id.* at 30. This is "consistent with the idea that the public and private enforcement mechanisms created by the act allowed [firms] to credibl[y] signal the accuracy of their disclosures." *Id.* at 31.

201. Mahoney & Mei, *supra* note 192, at 13.

202. *Id.* at 4.

reporting requirements to companies traded over the counter.[203] These studies are less sensitive to the critique that studying the initial impact of the '33 Act and '34 Act does not tell us much about the Acts' current impact given the emergence of "[i]nstitutional investors, securities analysis and the modern law of securities fraud."[204] Two of these studies look at the extension or expansion of reporting requirements to certain over-the-counter firms in 1964, whereas the third examines the extension in 1999 and 2000.

Michael Greenstone and colleagues, based on a sample of roughly a quarter of the 900 firms that first filed with the SEC after the passage of the 1964 Amendments, found a positive abnormal stock return resulting from the increased disclosure.[205] They attribute much of this gain to reduced agency costs, as the cost to outsiders from insider trading declined.[206] In contrast, Ferrell, based on a different sample and using different methodology, found no significant monthly abnormal excess return from the beginning of 1962 until the end of 1964.[207]

Bushee and Leuz's study looked at the impact of imposing '34 Act reporting requirements on all U.S. companies trading on the Over-The-Counter Bulletin Board (OTCBB). Before 1999 OTCBB issuers who had never issued securities under the '33 Act and were below certain size or security holder requirements were exempt from the '34 Act reporting requirements.[208] They found that 76% of companies not previously reporting under the '34 Act were removed from the OTCBB, resulting in market value and liquidity costs.[209] Of those companies that remained on the OTCBB—and thus were compelled to report—stock returns declined, suggesting that mandatory disclosure exceeded its benefits.[210] These results are not surprising, because any of the companies that thought the benefits of reporting would exceed the costs could have voluntarily chosen to file with the SEC. The companies that chose to stay on the OTCBB tended to be larger, more leveraged, and less profitable than those that did not, which, due to data availability issues, the authors cautiously report as suggesting "that an important consequence of mandatory SEC disclosures is to push smaller firms with lower outside financing needs into a less regulated market, rather than to

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203. Bushee & Leuz, *supra* note 192; Michael Greenstone et al., *Mandated Disclosure, Stock Returns and the 1964 Securities Acts Amendments*, 121 Q. J. OF ECON. 399 (2006); Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market* (The Harvard John M. Olin Discussion Paper Series, Discussion Paper No. 453, 2003), *available at* http://www.law.harvard.edu/programs/o/h_center/.

204. Coffee, *supra* note 149, at 744.

205. Greenstone et al., *supra* note 203, at 443.

206. Greenstone et al., *supra* note 203, at 444. Agency costs are a possible explanation of the results, given that companies could have voluntarily become subject to the '34 Act.

207. Ferrell, *supra* note 203, at 37. For a critique of Ferrell's study, see Greenstone et al., *supra* note 203, at 445.

208. The size thresholds were set out in section 12(g). Issuers with assets under $10 million or fewer than 500 securities owners-of-record were exempt from the '34 Act reporting requirements.

209. Bushee & Leuz, *supra* note 192, at 234–35.

210. *Id.* at 235–36.

compel them to" adopt higher disclosure standards.[211]

Bushee and Leuz also found a possible positive externality of extending reporting requirements, in that the OTCBB firms that were already reporting, whether or not voluntarily, benefitted from increased liquidity.[212]

In general, it is fair to conclude that the evidence on the overall desirability of the disclosure regime is mixed. The fact that these studies look at the overall impact on companies being subject to U.S. securities acts without separating the impact of different provisions is part of the problem.[213] Even if government-mandated disclosure is desirable for an efficient capital market, this conclusion does not mean that restrictions on the disclosure of accurate and nonmisleading information are justifiable. SEC regulations that prohibit disclosure render the market less efficient if some of the prohibited disclosure includes nonmisleading material information.[214] The arguments for market failure in the provision of information really apply only to the mandatory disclosure provisions. They do not apply to the restrictions, at least to the degree that the restrictions reach nonmisleading disclosure.

Furthermore, even if the net impact of imposing mandatory disclosure is positive or negative, the impact of individual provisions may be either. Thus, one explanation for the different results is that securities regulation included different provisions at different times. For example, in 1964, disclosure of forward looking information did not enjoy the safe harbor protection that it had in 1999.[215]

The argument against disclosure regulation in some instances is more compelling. For example, Jarrell and Bradley looked at the impact of the Williams Act of 1968.[216] The Williams Act requires would-be acquirers to disclose their business plans and delay implementation, thereby ensuring that investors have adequate information and time to make a decision.[217] The

211. *Id.* at 261.

212. *Id.* at 236. If small-cap investors refuse to trade on the Pink Sheets then that would also lead to an increase in liquidity due to increased investor demand for OTCBB firms. *Id.*

213. It is also worth remembering that securities regulations do not require full disclosure. In fact, full disclosure is only required when there is a duty to disclose, and in many instances a company has no duty to disclose even material information. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) (noting that silence will not be actionable unless there is a duty to disclose). Thus, when company *X* is about to buy company *Y*, but before an announcement is required, the shares of company *Y* are really worth something close to the takeover premium that company *X* will pay. The issue is thus actually about degree of pricing efficiency rather than whether it exists or not.

214. If the information is neither material nor misleading, then it is hard to see why the SEC restricts it.

215. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 102, 109 Stat. 737, 749. In fact, before 1973 the SEC actively discouraged the disclosure of forward looking information. *See* Disclosure of Projections of Future Economic Performance, Securities Act Release No. 33-9984, 34-9984 Fed. Sec. L. Rep. (CCH) 79,211, at 82,666 (Feb. 2, 1973).

216. Gregg A. Jarrell & Michael Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J. L. & ECON. 371, 373 (1980).

217. Williams Act, Pub. L. No. 90-439, § 2, 82 Stat. 454, 454–55 (1968) (codified as amended at 15 U.S.C. § 78m(d) (2000)).

problem, however, is this disclosure and delay allows other potential acquirers to free-ride on the first acquirer's bid. If a potential acquirer chooses to bid as well, the first acquirer's costs increase, or the target is lost. Therefore, although the Williams Act increased premiums that acquirers paid from 32% to 53%,[218] the Act also reduced the number of takeover bids.[219] Shareholders of targeted companies benefitted, but shareholders of companies that would have been targeted absent the passage of the Act lost.[220] In addition, acquirers lost the ability to fully profit from their knowledge of how to effect valuable corporation combinations.[221] Overall, Jarrell and Bradley concluded that the takeover regulations, "by precluding some takeovers and reducing the productivity of others, have incurred large social costs."[222]

There also have been several studies of Regulation FD. The results are inconclusive[223] or perhaps even indicate that the regulation has been harmful.[224]

Finally, there is some suggestive, albeit inconclusive and sometimes anecdotal, evidence regarding issuers' choices to go private, deregister, or list on foreign exchanges.[225] While these choices are likely motivated by more than just the securities regulation regime, disclosure provisions may play a role given their overarching importance.[226] This evidence suggests that the overall costs of securities regulation may now exceed the benefits.

Since the passage of the Sarbanes-Oxley Act, an increasing number of firms have chosen to deregister.[227] Commenting on this trend, Marosi and Massoud suggest that the SEC should consider reducing the reporting burden on smaller companies.[228] An increasing number of companies also appear to have gone private.[229] The media reports that "[e]veryone, it seems, wants to be private."[230]

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218. Jarrell & Bradley, *supra* note 216, at 389.

219. *Id.* at 399 ("Some investments and acquisitions that would be profitable absent the takeover law will be deterred by the higher tender premiums under the regulations.").

220. *Id.* at 404.

221. *Id.*

222. *Id.* This harm, of course, is produced by both the required disclosure and by the delay.

223. *See* Page & Yang, *supra* note 13, at 26–33 (reviewing studies).

224. *See* Peter Talosig III, *Regulation FD—Fairly Disruptive? An Increase in Capital Market Inefficiency*, 9 FORDHAM J. CORP. & FIN. L. 637, 714 (2004) (concluding, after a review of studies, that "[i]nvestors have received little benefits from [Regulation FD] and many more disadvantages").

225. Deregistering and going private are not synonymous. Companies that deregister no longer have to file reports with the SEC but can still be publicly traded on the Pink Sheets.

226. *See supra* notes 84–110 and accompanying text.

227. Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 44 J. ACCT. & ECON. (forthcoming 2007).

228. András Marosi & Nadia Massoud, *Why Do Firms Go Dark?*, 42 J. FIN. & QUANTITATIVE ANALYSIS 421 (2007).

229. *See* Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (Center in Law, Economics and Organization Research Paper Series and Legal Studies Research Paper Series 2006), *available at* http://ssrn.com/abstract=901769 (finding evidence "consistent with the hypothesis that SOX induced small firms to exit the public capital market during the year following [the Sarbanes-Oxley Act] enactment"); *see also* Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Decisions* (May 6, 2004), *available at* http://ssrn.com/abstract=546626 (investigating "firms' going-private decisions in response to the

Lastly, an increasing number of have firms have chosen to list on markets outside the United States. Piotroski and Srinivasan found "strong evidence that U.S. exchanges have experienced a decrease in foreign listings following the enactment of the [Sarbanes-Oxley] Act, and that this decline cannot be fully explained by changes in market conditions."[231]

This evidence does not, of course, show that disclosure regulation is unnecessary. It does, however, suggest that U.S. securities regulation is sub-optimal, which could affect a decision about not only whether to apply the First Amendment to securities regulation,[232] but also whether a particular regulation would survive.

2. *Would Securities Regulations Survive First Amendment Scrutiny?*

The foregoing discussion is not only relevant to whether the mandatory disclosure regime is necessary, but also relevant, if the First Amendment were applicable, to whether challenges would be successful. Notwithstanding the lack of clear evidence, several reasons lead to the conclusion that most securities regulations, particularly those mandating disclosure, would survive such challenges.[233] At least one SEC rule has survived strict First Amendment scrutiny.[234]

First, the *Central Hudson* standard of review is flexible, or as some

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passage of the Sarbanes-Oxley Act").

230. *See* Andrew Ross Sorkin, *A Growing Aversion to Ticker Symbols*, N.Y. TIMES, Jan. 28, 2007, at C6.

231. Joseph D. Piotroski & Suraj Srinivasan, *The Sarbanes-Oxley Act and the Flow of International Listings* 31 (2007), *available at* http://ssrn.com/abstract=956987. They conclude that their "evidence is consistent with a shift in both the expected costs and benefits of a foreign listing following the enactment of Sarbanes-Oxley." *Id.* at 1; *see also* Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US*, J. CORP. FIN. (forthcoming 2007) (finding evidence "consistent with the view that investors expected the Sarbanes-Oxley Act to have a net negative effect on cross-listed foreign companies"); Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L. REV. (forthcoming 2007) [hereinafter *Cross-Listing Premium*] (finding a significant decline in cross-listing premium for foreign companies subject to the Sarbanes-Oxley Act compared to foreign companies not subject to the Act). Litvak also found that "[c]ompanies that were already high-disclosing (or from high-disclosing countries) suffered the largest adverse effect." Litvak, *Cross-Listing Premium*, *supra*.

232. Granted, the Constitution only guarantees a republican form of government, as opposed to effective governance. *See* Dooley, *supra* note 34, at 335. To reiterate, however, if the application of the First Amendment depends in part on the nonlegal economic context, then the effectiveness of securities regulation would be relevant. *See supra* notes 129–30 and accompanying text.

233. Although it is beyond the scope of this Article to analyze specific regulations in depth, see Page & Yang, *supra* note 13, at 64–81, for a thorough analysis of the First Amendment's application to Regulation FD. *See also*, Drury, *supra* note 116, at 786–88.

234. Blount v. SEC, 61 F.3d 938, 944–48 (D.C. Cir 1995). The *Blount* court upheld Rule G-37 that restricted political contributions by parties involved in the municipal securities market ("pay-to-play"). The court applied strict scrutiny rather than intermediate scrutiny without deciding which level was appropriate. *Id.* at 943.

commentators have described it, indeterminate.[235] Also, in the First Amendment context, judges may be particularly pragmatic.[236] Pragmatic judges applying an indeterminate First Amendment standard to highly valued mandatory disclosure provisions seem likely to uphold them.[237]

Second, under *Central Hudson*, if the SEC can show, as it clearly believes, that issuer speech may at least in some circumstances mislead potential investors, the regulations affecting such speech would likely survive. The Supreme Court has, for example permitted such regulation in the context of attorney advertising.[238] Appropriate restrictions are permitted, provided they do no more to prevent the possible deception than what is reasonably necessary.[239] With respect to prohibitions on commercial speech, the SEC passed new rules, effective December 1, 2005, that addressed some of the key problems with the public offering process, including First Amendment problems.[240]

Third, judicial evaluation, regardless of the standard of review, will involve an inquiry into the ends and means.[241] For the most part, the securities regulation's ends—efficient securities markets and fraud prevention—[242] are

235. Volokh, *supra* note 40, at 733 (stating that "even if *Central Hudson* still provides the official test, that test is notoriously indeterminate").

236. Suzanna Sherry, *Hard Cases Make Good Judges*, 99 NW. U. L. REV. 3, 4 (2004) (arguing that for First Amendment cases, "pragmatic considerations rather than grand principles often determine the outcome, producing some unpredictability but a just regime overall").

237. Friedman v. Rogers, 440 U.S. 1, 11 n.9 (1980) (stating that "[b]ecause of the special character of commercial speech and the relative novelty of First Amendment protection for such speech, we act with caution in confronting First Amendment challenges to economic legislation that serves legitimate regulatory interests").

238. *In re* R.M.J., 455 U.S. 191, 203 (1982); *see also* Zauderer v. Office of Disciplinary Counsel, 471 U.S. 626, 650–51 (1984) (observing that mandatory disclosure of truthful information posed fewer First Amendment problems than restrictions).

239. *In re R.M.J.*, 455 U.S. at 203.

240. Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722 (Aug. 3, 2005), *available at* http://www.sec.gov/rules/final/33-8591.pdf. The new rules allow a much broader range of communications between issuer and investor both before and after the filing of a registration statement. For example, all issuers are now permitted to publish at any time during the securities registration process all regularly released factual business information. Most issuers will also be able to communicate regularly released forward looking information. Because mandatory prohibitions on the publication of nonmisleading information are one of the most constitutionally suspect areas of securities regulation under the First Amendment, this liberalization assists the SEC in arguing that their regulations are effectively tailored to reducing the harm. It would not be conclusive, however, in that several kinds of issuers are not eligible for the new treatment. Interestingly, this regulatory change has apparently not yet resulted in a behavioral change with respect to some quiet period disclosures. *See* Lynn Cowan, *In the 'Quiet Period,' Mum's Still the Word—New Leeway to Talk of IPOs' Prospects Gains Few Takers*, WALL ST. J., Jan. 29, 2007, at C6. This suggests that even if some regulations were struck down, the consequences might be trivial. *Accord* Schauer, *supra* note 5, at 1806 (observing that after "thousands of publishers were freed from the legal obligation to register with the SEC, only twenty took advantage of the privilege").

241. Whether the courts use intermediate or strict scrutiny may no longer matter much. *See supra* notes 40–45 and accompanying text.

242. *See, e.g.*, Schoeman, *supra* note 114.

likely to be compelling.[243] The more contested part of any First Amendment attack will be the means inquiry. If strict scrutiny is applied, the means must be narrowly tailored. If intermediate *Central Hudson* scrutiny is applied, the means must simply and directly advance the governmental interest and not be more extensive than necessary.

The means seem particularly suspect with respect to SEC restrictions that burden or restrict disclosure. Recall that commercial speech is protected because of its value to the listeners.[244] Restricting speech—at least speech that is not false, deceptive, misleading or proposing an illegal transaction—depends on a paternal assumption that listeners or readers will be harmed by such speech, presumably by making an unwise investment decision. It also necessarily assumes that the SEC can reasonably identify ex ante which types of speech will most likely cause such harm and which will not. These restrictions appear "to keep people in the dark for what the government believes to be their own good."[245] If, however, the SEC can demonstrate that, in addition to restricting truthful and nonmisleading speech, it is also restricting deceptive or misleading speech, and that its restriction is "narrowly drawn," that would likely be

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243. Boyer makes an interesting argument regarding how requiring disclosure affects the underlying corporation:

> As a matter of structure and process, the fact that certain issues must be disclosed ensures that information on those issues will be gathered and action on those issues taken. . . . The prospectus and registration statement are not printed solely to reveal information about the offering. They are printed as a means of ensuring that the issues they disclose have been addressed: that facts have been ascertained, assumptions consciously formulated, and decisions made at specific junctures by responsible parties.

Boyer, *supra* note 46, at 483–84.

Going beyond the registration statement, another example of this might be the Sarbanes-Oxley Act requiring that companies disclose whether their internal controls were adequate or not. Not surprisingly, companies forced to disclose inadequate controls would then improve those controls.

Simply because disclosure may affect substance, however, is not a reason for exempting securities regulation from First Amendment coverage. Rather, if the substance is desirable, it might cut in favor of direct regulation. *See* Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 149 (2006) (arguing in favor of direct regulation). *But see* Schwarcz, *supra* note 172, at 27 (arguing against direct regulation). If a state decides that companies' internal controls should be enhanced, it can simply require it directly. Alternatively, the substantive impact of a disclosure regulation would be merely another interest that the government could use to justify its regulation, and the means, requiring disclosure, is subject to scrutiny.

There may also be a harmful effect to this disclosure. Geoffrey Manne argues that "forced disclosure may induce unwanted responses" because disclosure affects the relative costs of different kinds of behavior. Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 57 ALA. L. REV. 473, 477 (2007). Corporate conduct will thus be shifted on the margins towards lower cost activities, even if these activities are "less beneficial than the regulated, deterred behavior." *Id.*

244. *See supra* note 15 and accompanying text.

245. Rubin v. Coors Brewing Co., 514 U.S. 476, 497 (1995) (Stevens, J., concurring); *see also* Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 769 (1976) ("[T]he State's protectiveness of its citizens rests in large measure on the advantages of their being kept in ignorance.").

adequate.[246] The Supreme Court has already noted that "the free flow of commercial information is valuable enough to justify imposing on would-be regulators the costs of distinguishing the truthful from the false, the helpful from the misleading, and the harmless from the harmful."[247]

Broadly speaking, the least important provisions of the securities regulation regime, like those burdening the disclosure of nonmisleading information, are most likely to be struck down. The most important of these provisions, such as those mandating disclosure of material commercial information, appear unlikely to be struck down.

V. CONCLUSION

The arguments that the First Amendment should not apply to securities regulation because securities are uniquely different from other products or that capital markets must necessarily be regulated are unpersuasive, particularly since there are viable alternatives to a mandatory federal securities regime. Even accepted on their terms, these arguments do not supply a justification for an exemption so much as justify some or all of the mandatory disclosure requirements withstanding First Amendment scrutiny. These arguments offer little, if any, justification for securities regulations that restrict or burden speech. Similarly, they do not appear to address issues such as compelling companies to carry shareholders' speech.[248]

The application of the First Amendment to securities regulation, however, is not as troublesome as one might think.[249] The argument here should not be characterized as a *Lochner*-like argument in favor of laissez-faire economics.[250] It seems more likely that most securities regulations facing First Amendment scrutiny would survive. Even if they were struck down, the consequences are

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246. *See, e.g.*, Fla. Bar v. Went For It, 515 U.S. 618, 624 (1995) (quoting Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n, 447 U.S. 557, 564–65 (1980)) (stating the *Central Hudson* three prong test for speech that is not misleading or unlawful); Edenfield v. Fane, 507 U.S. 761, 768–69 (1993) (stating that where nonmisleading speech is regulated along with misleading speech, the regulation must pass the *Central Hudson* test).

247. Zauderer v. Office of Disciplinary Counsel, 471 U.S., 626, 646 (1985).

248. Boyer's defense of the inapplicability of the First Amendment to speech in the context of proxy contests relies on the general reasoning that the greater power includes the lesser power (i.e., because state law creates the corporation, the state and the SEC can also govern the relationship between different members of the corporation). The Supreme Court had previously accepted this line of reasoning in the context of a challenge to a statue that restricted casino advertising even as it allowed casinos. *See* Posadas de P.R. Assocs. v. Tourism Co. of P.R., 478 U.S. 328, 346 (1986) ("[I]t is precisely *because* the government could have enacted a wholesale prohibition of the underlying conduct that it is permissible for the government to take the less intrusive step of allowing the conduct, but reducing the demand through restrictions on advertising."). This reasoning has since been discredited. *See* 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 509–10 (1996).

249. Admittedly, one possible consequence of a securities regulation being struck down under the First Amendment would be the state achieving the same effect through direct regulation. *See supra* note 244.

250. Boyer, *supra* note 46, at 477.

unlikely to be disastrous. The end result—that regardless of the level of scrutiny the SEC would have to justify its regulations, particularly with respect to restrictions on the disclosure of truthful nonmisleading information—would likely result in better, more effective securities regulation and consequently stronger capital markets.